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Audits of state and local governmental units (1974) including Statement of Position (75-3); Audit and accounting guide:

American Institute of Certified Public Accountants. Committee on Governmental Accounting and Auditing

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INDUSTRY AUDIT GUIDE

AUDITS OF STATE AND LOCAL GOVERNMENTAL UNITS

**PREPARED BY THE COMMITTEE ON
GOVERNMENTAL ACCOUNTING
AND AUDITING**

NOTICE TO READERS

This audit guide is published for the guidance of members of the Institute in examining and reporting on financial statements of state and local governmental units. It represents the considered opinion of the Committee on Governmental Accounting and Auditing and as such contains the best thought of the profession as to the best practices in this area of financial reporting. Members should be aware that they may be called upon to justify departures from the Committee's recommendations.

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AUDITS OF STATE AND LOCAL GOVERNMENTAL UNITS

**PREPARED BY THE COMMITTEE ON
GOVERNMENTAL ACCOUNTING
AND AUDITING**

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Preface

This guide has been prepared to assist the independent auditor in examining and reporting on financial statements of governmental units other than the federal government.

While the material contained herein is applicable to both state and local governmental units, the discussion, procedures, and exhibits are directed primarily to local units.

Proper use of this guide requires thorough knowledge of *Governmental Accounting, Auditing, and Financial Reporting* (GAAFR), published in 1968 by the National Committee on Governmental Accounting (NCGA). This book, often referred to as the "blue book," is addressed primarily to financial management and accounting personnel of governmental units and deals with procedural and management matters as well as accounting principles.

The blue book and this audit guide represent significant steps in the evolution of governmental accounting and financial reporting. This evolutionary process is continuing even today.

Effective Date and Retroactive Application

The provisions of this guide shall be effective for periods beginning on or after January 1, 1974. Earlier compliance is encouraged.

Adjustments to financial statements resulting from a change in accounting principle to comply with the recommendations of this audit guide should be treated as adjustments of prior periods, and financial statements for periods previously reported upon should be restated as appropriate. Paragraph 28 of APB Opinion No. 20 describes the disclosures in financial statements required for changes in accounting principles. Statement on Auditing Standards No. 1, "A Codification of Auditing Standards and Procedures," illustrates the wording of the auditor's report for such restatements.

*Committee on Governmental
Accounting and Auditing*

September 1973

Characteristics of Governmental Accounting

Chapter I

Growth and Development of Governmental Accounting

Background—State and Local Governmental Units

The federal government is generally considered the predominant employer and source of expenditures for governmental units. However, since World War II, state and local government employment and expenditures have been expanding faster than those in the federal sector. Based on the most recent census,¹ one of every six persons in civilian nonfarm employment is included on the payroll of a governmental unit. Expenditures of governmental units represent approximately one-third of the gross national product and the proportion has been steadily increasing. Civilian employment in all branches of government currently exceeds 13 million persons with state and local governments accounting for over 10 million persons. A 65 percent increase in the number of state and local employees has occurred since 1961. Thus, the rapid growth of governmental activities has greatly increased the need for governmental accounting and auditing services.

¹ U.S. Bureau of Census, "Governmental Units in 1972," Census of Governments—1972 (Washington: U.S. Department of Commerce, December 1972).

The latest census reported 78,267² state and local governmental units, classified in the following categories:

States	50
Counties	3,044
Townships	16,991
Municipalities	18,516
School districts	15,780
Special districts	23,886
Total	<u>78,267</u>

The number of local governmental units varies considerably from state to state because there is a greater proliferation of units in some jurisdictions than in others.

Recent censuses have shown a declining trend in the total number of units within the above categories principally due to consolidation of school districts. All other units have remained relatively stable except special districts, which have increased markedly in number. The increasing public demand for services from government is sometimes satisfied by existing units, but frequently special districts or other units have been formed to provide the new services. The variety of these special districts, authorities, or commissions is too great for an inclusive listing, but the following are examples:

port authorities	public buildings	water
airports	libraries	parks
railroad terminals	fire protection	forest preserves
roads and bridges	public health	soil and water
transportation	sanitation	conservation
industrial develop-	hospitals	river conservance
ment	housing develop-	mosquito abate-
parking	ment	ment

Opportunity for Service

In view of the expanding role of state and local governmental units in recent years, the opportunity for service by independent auditors is greater than ever before.

² U.S. Bureau of Census, "Governmental Units in 1972."

Twenty-six years ago an AIA (AICPA) Committee on Governmental Accounting offered the following comment:

... governmental accounting offers a relatively undeveloped field in which the accounting profession has an opportunity to render substantially increased services . . . on a basis which will add materially to the prestige of the profession and will represent a worthwhile contribution to better government.³

Since then the overall quality of governmental accounting and auditing has improved greatly. Much credit for these improvements is due to the National Committee on Governmental Accounting and many governmental agencies and associations, including the United States Government General Accounting Office, Federal Government Accountants Association, Municipal Finance Officers Association of the United States and Canada, and the National Association of State Auditors, Comptrollers, and Treasurers. Contributing also to this improved quality has been the increased utilization of the independent audit as a form of control by governmental units. In the past two decades many states have adopted laws requiring independent audits of local governmental units.

State and local governmental audit engagements will frequently expand into management advisory services engagements. Recently, there have also been significant developments which encourage the extension of audit engagements to include reporting on compliance and performance areas.

The personal and professional challenges and opportunities for the CPA, his firm, and his profession in governmental accounting, auditing, and management advisory services are immense. These challenges and opportunities for service are certainly as great as, if not greater than, those in the private sector.

³ *Reports to Council* (New York: American Institute of Accountants, May 1947), p. 10.

Chapter 2

Accounting Principles and Concepts

Introduction

This chapter discusses generally accepted accounting principles applicable to governmental units and describes some basic distinctions between accounting for governmental units and accounting for commercial enterprises.¹

A recognition of the purpose of financial statements for a governmental unit is essential to an understanding of the applicable accounting principles. Governmental units are organized by the citizenry to provide for the management of public affairs and to provide other services to the general public. In providing such services, the operations of government are “controlled by legal provisions in constitutions, statutes, charters, appropriation acts, and administrative regulations having the force and effect of law.”² Therefore, a principal purpose of presenting financial statements is to report on the stewardship of public officials with respect to public funds. However, other groups vitally concerned

¹ As used in this guide, the term “commercial enterprise” is synonymous with the term “business enterprise” and hence includes all profit-making organizations.

² *Governmental Accounting, Auditing, and Financial Reporting* (GAAFR), p. 1.

with the cost of public services and the adequacy of revenues to meet such costs include management, legislative bodies, the general public, other governmental jurisdictions, and educational and research organizations. Also, investors, investment bankers, and bond-rating services are interested in the financial status and operating results of governmental units for the purpose of appraising the value of existing bonds as well as determining credit worthiness with respect to future borrowings.

Characteristics of Governmental Accounting

Governmental operations and commercial enterprises share a number of similar accounting concepts, such as the use of historical cost for reporting, materiality, full disclosure, and consistency; however, there are a number of distinctive characteristics of accounting for governmental operations that are of importance. These are summarized as the following:

1. There are two broad categories of governmental operations.
 - (a) Recurring operations oriented to providing services without producing profit in contrast to the pursuit of profit commonly found in commercial enterprises. These operations normally are controlled by a legal budget and accounted for within separate self-balancing groups of accounts commonly referred to as *budgetary funds*, i.e., the general fund, special revenue funds, and debt service funds.
 - (b) Operations providing services similar to those rendered by commercial enterprises, such as essentially self-supporting utilities. These operations, which follow accounting practices similar to those of commercial enterprises, normally are found in enterprise funds, intragovernmental service funds, and, to some extent, in trust and agency funds.
2. The effective financial control for operations of governmental units is accomplished through the use of fund and budgetary accounting.
3. In governmental accounting, there is a strong emphasis on legal compliance, a form of control exercised by the public through laws enacted by their representatives.

4. Cash basis accounting is sometimes appropriate in accounting for certain transactions.
5. The accounting for general fixed assets and long-term liabilities is unique and is discussed further on pages 17-19.
6. Accounting for capital expenditures is influenced by the category of the funds (see item 1, above) from which the expenditure is made. In enterprise, intragovernmental service, and certain trust funds, capital expenditures are capitalized in the fund, since the objectives of accountability are similar to those of commercial enterprises. In all other funds making capital expenditures, including general, special revenue, capital projects, and special assessment funds, the capital expenditures are treated in the same manner as other current expenditures in the fund and are (with certain exceptions) then capitalized in the general fixed asset group of accounts.

Thirteen "Basic Principles" of the NCGA

A body of accounting practices for governmental units, that has received the general endorsement of governmental officials, the general public, and other persons interested in the financial statements of such units, has evolved over the years. The National Committee on Governmental Accounting (NCGA) in its publication entitled *Governmental Accounting, Auditing and Financial Reporting* (GAAFR), which has been acknowledged as an authoritative publication in the area of accounting for governmental units, has set forth 13 "basic principles" to be applied in accounting for governmental operations.³ The 13 "basic principles" address the following subjects:

1. Legal compliance and financial operations.
2. Conflicts between accounting principles and legal provisions.
3. The budget and budgetary accounting.
4. Fund accounting.
5. Types of funds.

³ See Appendix A for a reproduced listing of these principles, as set forth in GAAFR, pp. 3-14.

6. Number of funds.
7. Fund accounts.
8. Valuation of fixed assets.
9. Depreciation.
10. Basis of accounting.
11. Classification of accounts.
12. Common terminology and classification.
13. Financial reporting.

GAAFR's principles do not represent a complete and separate body of accounting principles, but rather are a part of the whole body of generally accepted accounting principles which deal specifically with governmental units. Except as modified in this guide, they constitute generally accepted accounting principles.

These principles vary with respect to their significance in relation to financial reporting. Therefore, for purposes of discussing generally accepted accounting principles applicable to financial reporting by governmental units, this guide has organized GAAFR's principles into the following seven "Combined Principles" subject areas:

<u>Combined Principles</u>	<u>Corresponding Principles of NCGA</u>
Fund accounting	Nos. 4 through 7
Budgets and budgetary accounting	No. 3
Legal compliance	Nos. 1 and 2
Bases of accounting	No. 10
Fixed asset accounting	Nos. 7 (part) through 9
Long-term liabilities	No. 7
Financial statements	Nos. 11 through 13

Combined Principles

Fund Accounting. The diverse nature of governmental operations and the necessity of complying with legal provisions require accounting systems unlike those commonly used by commercial enterprises. Rather than establishing a single unified set of accounts for recording and summarizing all financial trans-

actions, the accounts of a governmental unit are organized on the basis of funds or account groups, each of which constitutes a separate entity. Thus, the operations of each fund are accounted for by providing a separate set of self-balancing accounts which comprise its assets, liabilities, fund balance or retained earnings, revenues and expenditures, or expenses.

In working with governmental units, the independent auditor will find the term "fund" used to mean different things in differing situations. A common example is the requirement in many revenue bond indentures for segregation of monies into separate "funds." While the existence of such documents may require a delineation in accounting and reporting, the separate "funds" are, in reality, separate accounts, not "funds," as the term is used in this guide.

Interfund transactions—Since each fund is considered as a separate entity, amounts receivable from or payable to other funds should be reflected in the accounts of each fund and separately presented in the financial statements until liquidated by payment or authorized interfund transfer.

In addition to interfund loans and advances, there are essentially four categories of interfund transactions. Guidelines and examples for proper accounting of these four categories of interfund transfers, which may be subject to budgetary considerations, are set forth in the following paragraphs:

1. The first category includes transfers which are revenues to the recipient fund and expenditures to the disbursing fund. These are transactions which would be treated as revenues or expenditures if they were conducted with outsiders. An example would be a contribution in lieu of property taxes to a municipality's general fund from an enterprise fund, such as a municipal utility. Other examples include billings by an intragovernmental service fund to departments of a general fund for services rendered or facilities provided and for services rendered by a general fund to one or more special revenue or enterprise funds, such as engineering, legal, and administrative assistance.
2. In the second category are transfers which comprise reimbursement of expenditures made by one fund for another and which are credited to the expenditures of the recipient

fund or shown as a reduction of total expenditures. Interfund transfers represent reimbursement for an expenditure if the reimbursement is for a specific or directly allocable cost applicable to the reimbursing fund. Generally, these items will be of the type subject to direct allocation at the point of inception and, where the timing of the transfer (or direct usage) makes this feasible, governmental units should so record them. An example would be the transfer of materials from a general fund department to an intragovernmental service fund.

3. The third category is comprised of recurring annual transfers between two or more budgetary funds for the purpose of shifting resources from the fund legally required to receive the revenue to the fund authorized to expend the revenue, which should be segregated from normal revenues or expenditures. Frequently, statutes will not permit a direct allocation of a revenue source between two funds. Accordingly, it is necessary to have an annual transfer from the fund legally required to receive the revenue to a fund authorized to expend all or some portion of the revenue. An example would be an annual transfer from a state's general fund to the state's school aid fund. Such transfers are not true revenues and expenditures of the respective funds. However, the total transfers received and the total transfers disbursed should be included as separate items in each fund's statement of revenues and expenditures or equivalent financial statement. (See "Illustrative Forms of Certain Financial Statements and Supplemental Schedules of Governmental Units," example 5, p. 103.)
4. The last category includes nonrecurring transfers between funds which represent a transfer of equity of the funds involved. Nonrecurring transfers of equity between funds that are extraneous to normal operations are not revenues and expenditures of the funds involved. Such transfers, which are analogous to capital transactions, should not be reported in the statement of revenues and expenditures. Examples would include contributions from the general fund to enterprise and intragovernmental service funds, return of part or all of such contributions to the general or other contributing fund, and transfers of residual equity balances in discontinued funds

to the general or debt service funds, normally required by statute. In all such cases, the recipient fund should treat the amount received as an addition to fund balance or, in the case of an enterprise or intragovernmental service fund, to a contribution account. The disbursing fund should treat the transfer as a reduction of fund balance, or in the case of an enterprise or intragovernmental service fund, retained earnings, if a contribution account is not properly chargeable.

Budgets and Budgetary Accounting. Because of the significance of budgets to certain governmental operations and their relationship to the financial statements of governmental units, the subject is discussed separately in Chapter 3.

Legal Compliance. GAAFR specifically provides:

2. If there is a conflict between legal provisions and generally accepted accounting principles applicable to governmental units, legal provisions must take precedence. . . .⁴

The primary responsibility of governmental officials is to comply with the law and one of the purposes of the accounting system is to enable ready disclosure of compliance with appropriate legal provisions.

However, this requirement for compliance to be expressed in the accounting system does not obviate generally accepted accounting principles for purposes of reporting financial position and results of operations.

In financial reporting, in the event of conflict between legal provisions and generally accepted accounting principles, the latter should take precedence. Accordingly, the following restatement of the legal compliance accounting principle is appropriate:

A governmental accounting system should incorporate such accounting information in its records as necessary to make it possible to both (a) show compliance with all applicable legal provisions and (b) present fairly the financial position and results of operations of the respective funds and financial position of the self-balancing account groups of

⁴ GAAFR, p. 4.

the governmental unit in conformity with generally accepted accounting principles. Where these two objectives are in conflict, generally accepted accounting principles take precedence in financial reporting.

Where there is a need to report the compliance of financial transactions with legal requirements and it can be reported in supplemental schedules, this form should be used.

Reference is made to Chapter 7 for guidance in preparation of the independent auditor's report where circumstances involve application of the above restated principle.

Bases of Accounting. The basis of accounting to be followed in recording transactions in the respective funds of a governmental unit depends on the purpose for which a fund has been established. Generally, the funds can be classified into two categories.

1. Funds utilizing accrual basis

- (a) Funds similar to commercial enterprises
 - (i) Enterprise
 - (ii) Intragovernmental Service
- (b) Other governmental funds (see exceptions below)
 - (i) Capital Projects
 - (ii) Trust and Agency
 - (iii) Special Assessment

An exception to the use of the accrual basis for funds under (b) above would be those instances wherein revenues received by the fund were not susceptible to accrual, in which instance revenues would be recorded as collected (see discussion on pages 14-15).

In special assessment funds, interest income on assessments receivable and interest expense on offsetting bonds payable or other long-term debt should not be accrued unless fully matured and not paid. Interest income and expense are related in a special assessment fund because the resources required to pay interest on long-term debt are derived from the collection of interest income on assessments receivable. Both the collection and payment dates are fixed by local ordinance and no prac-

tical purpose is served by accruing interest on either item between the respective due dates and a given balance sheet date.

2. Funds utilizing modified accrual basis

- (a) Budgetary Funds
 - (i) General
 - (ii) Special Revenue
 - (iii) Debt Service

These funds are established primarily to account for the resources and expenditures for governmental operations of a general nature. The financial operations of these funds consist of the marshalling of resources and the expenditure of such resources. Ordinarily there is no causative relationship as the resources are not expended for the purpose of creating or producing the resources. The resources of budgetary funds are derived largely from the imposition of taxes by the governmental unit.

A classification and discussion of the factors inherent in the use of the modified accrual basis of accounting for budgetary funds is as follows:

1. Revenues are recorded as received in cash except for (a) revenues susceptible to accrual and (b) revenues of a material amount that have not been received at the normal time of receipt.

a. *Revenues susceptible to accrual.* Generally revenues should be recorded on the accrual basis only if they are susceptible to accrual. Being susceptible to accrual implies more than being measurable. Revenues considered susceptible to accrual are those revenues that are both measurable and available. In substance, "available" means that the item is a resource that can be used to finance the governmental operations during the year.

Few types of revenues in budgetary funds possess all of the characteristics essential to meet both criteria of being measurable and available, which are requisite to being considered susceptible to accrual.

Revenue sources that generally are not considered susceptible to accrual include those generated on a self-assessed basis, such as income taxes, gross receipts taxes, and sales taxes. Normally, such taxes would be recorded as revenue when received. However, known refunds of such taxes should be recorded as a

liability and a reduction of revenue as of the time the refund claims are filed with the taxing authority.

Normally, when an item is billable by the governmental unit, and there is evidence that there is a valid receivable, it would be recognized as revenue at that point. However, business licenses, for example, for a particular fiscal year, even if billed before the year begins, would not constitute revenue in advance of the license year for the reason that the benefit period to the license holder normally does not commence until actual renewal. Further, some of the business concerns billed may not renew their licenses for one reason or another. The point of accrual usually coincides with the time of renewal, generally the time of payment. For these reasons, business licenses are generally not considered susceptible to accrual.

One major source of revenue which may or may not be accruable is property taxes. In many jurisdictions throughout the country, accounting for property taxes is on a cash basis because a portion or all of the payment is not due until the year following the year billed. Timing considerations and the availability of such revenues to meet expenditures in the related budget year should be considered in determining whether or not property taxes should be accrued.

The preceding discussion as to susceptibility to accrual pertains also to federal, state, or other grants. In applying this definition, the terms of the grant have to be reviewed for guidance. Generally, if expenditure of funds is the prime factor for determining eligibility for the grant funds, revenue should be recognized at the time of making the expenditure.

b. *Revenues of a material amount.* Some revenues, even though not susceptible to accrual, should be recorded prior to actual receipt. Generally, material revenues otherwise not recorded until received should be accrued if receipt is delayed beyond the normal time of receipt. For example, if material sales tax revenues should have been received prior to the financial statement date but are delayed until after statement date, the amount should be accrued.

Material revenues received prior to normal time of receipt should be recorded as deferred revenue. For example, if sales tax revenue normally is received after the financial statement date, but for some reason is received before the financial state-

ment date, the amount should be recorded as deferred revenue until time of normal receipt.

2. Expenditures are recorded on the accrual basis, except in the instances discussed below.

Disbursements for inventory type items may be considered as expenditures at the time of purchase or at the time the items are used.

Normally expenditures are not divided between years by the recording of prepaid expenses, for example, prepaid insurance.

Interest on long-term debt, commonly accounted for in debt service funds, normally should be recorded as an expenditure on its due date, as set forth in GAAFR.

The encumbrance method of accounting for expenditures for budgetary funds may be adopted, representing an additional modification to the accrual method of accounting. Under this method, commitments, such as purchase orders and contracts, in addition to expenditures made or accrued, are recorded. Subsequently, when the actual expenditure takes place, the accounts are adjusted for any difference between the actual expenditure and the commitment previously recorded. If such a difference is recordable in the same year in which the encumbrance was made, the adjustment should be made to the original expenditure account charged. If the difference is recordable in a year subsequent to the year in which the encumbrance was made, the adjustment should be made to a sundry expenditure account in the nondepartmental category of the related fund. An outstanding encumbrance is recognized as an expenditure and the related obligation is carried until liquidated, either by replacement with an actual liability or by cancellation.

A summary of the modifications to the accrual method of accounting for budgetary funds, i.e., the general fund, special revenue, and debt service funds, follows:

1. Revenues are recorded as received in cash except for
 - (a) revenues susceptible to accrual and
 - (b) material revenues that are not received at the normal time of receipt.
2. Expenditures are recorded on an accrual basis except for
 - (a) disbursements for inventory type items, which may

- be considered expenditures at the time of purchase or at the time the items are used;
- (b) prepaid expenses, which normally are not recorded;
 - (c) interest on long-term debt, which should normally be an expenditure when due; and
 - (d) the encumbrance method of accounting, which may be adopted as an additional modification.

Accounting for General Fixed Assets and Depreciation Thereon

The purposes of recording general fixed assets are primarily stewardship needs to provide for physical and dollar value control and secondarily for an accountability for general government capital expenditures over the years. Such assets should be recorded at historical cost, or estimated historical cost if the original cost is not available, or, in the case of gifts or contributions, at fair market value at the time received.

There is one category of general fixed assets for which recording for stewardship purposes is less significant than for other categories. These assets, consisting of certain "improvements other than buildings," are limited to non-enterprise capital expenditures relating to roads, bridges, curbs and gutters, streets and sidewalks, drainage systems, and lighting systems. Such assets normally are immovable and of value only to the governmental unit. For the same reasons, the need for cumulative accountability is not significant.

It is optional, therefore, whether such improvements other than buildings are recorded in the general fixed asset group of accounts. In either case, the applicable principle of capitalization should be stated in the disclosure of accounting policies for the general fixed asset group of accounts.

With respect to depreciation of general fixed assets, there are two reasons for a renewed interest in the subject. One is the increasing trend in the number of governmental grants, both of federal to state and local, and of state to local, which allow depreciation as a reimbursable cost. Another is the need to marshal all costs including depreciation for the purposes of measuring cost of governmental services and evaluating the efficiency of programs.

There are four reasons for computing depreciation for governmental units: (1) profit measurement for enterprise and intragovernmental service funds, (2) cost accounting for services and programs, (3) as a cost to be included in the basis for reimbursements or grants, and (4) systematic amortization of cost to recognize use or obsolescence. Granted these reasons for computing depreciation, however, maintaining such information and including it in financial statements involve separate questions.

Depreciation should be recorded on fixed assets financed primarily by charges to users, such as those included in enterprise and intragovernmental service funds. With respect to general fixed assets in a general fixed assets group of accounts, some financial statement users may prefer that depreciation be computed and reported even though such amounts are not a charge against any fund. Accordingly, as long as original cost or other appropriate amounts are maintained and reported, there is no objection to reflecting an allowance for depreciation in the general fixed assets group of accounts with a corresponding reduction in the amount shown as the investment in such assets. Where the amount shown as the investment in such assets is categorized by source of investment, the reduction may be shown as a reduction of the total of such categories.

In summary, the following two practices are considered acceptable:

1. In the general fixed assets group, certain "improvements other than buildings" are not required to be capitalized.
2. An allowance for depreciation may be deducted from the related assets in the general fixed assets group of accounts, with a contra reduction in the investment in the general fixed assets account.

Long-Term Liabilities

A portion of GAAFR's Principle No. 7 is quoted in the following statement.

Except for enterprise and special assessment funds (and certain trust funds), long-term liabilities . . . should not be carried . . . (as) liabilities of any fund, but should be set up in a separate, self-balancing group of accounts known as the General Long-Term Debt Group of Accounts.

GAAFR states further that

General obligation bonds and other forms of long-term debt supported by general revenues are obligations of a governmental unit as a whole and not its individual constituent funds. Moreover, the proceeds of such debt may be spent on facilities which are utilized in the operations of several funds. For these reasons, the amount of unmatured long-term indebtedness which is backed by the full faith and credit of the government should be recorded and accounted for in a separate self-balancing group of accounts titled the "General Long-Term Debt Group of Accounts." This debt group will include, in addition to conventional general obligation bonds, time warrants and notes which have a maturity of more than one year from date of issuance.⁵

With respect to reporting of general obligation bonds financing enterprise improvements and related disclosure requirements, see page 79 of Chapter 6.

Financial Statements

GAAFR's Principles (Nos. 11, 12, and 13) discuss the subjects of account classifications and financial reports. These subjects encompass basic record keeping and management as well as financial statements. This audit guide is concerned only with the conformity of financial statements with generally accepted accounting principles and an auditor's examination and reporting upon such statements.

As outlined in GAAFR Principle No. 5, each fund of a governmental unit will fall into one of eight types: (1) the general fund, (2) special revenue funds, (3) debt service funds, (4) capital project funds (sometimes referred to as capital improvement funds), (5) enterprise funds, (6) intragovernmental service funds, (7) trust and agency funds, and (8) special assessment funds. Each fund of a governmental unit constitutes a separate entity. Homogeneous funds may be consolidated in a single balance sheet, but it is not appropriate to consolidate funds of different types or to consolidate account groups.

Whether separate funds are homogeneous is a determination that must be made in each case. On the one hand, a number of special assessment funds for construction of sidewalks would

⁵ GAAFR, p. 101.

clearly be homogeneous. On the other hand, enterprise funds for a water system and operation of a parking structure would not be homogeneous. Between these two examples of extremes, judgment must be exercised.

A single set of consolidated financial statements for all funds and account groups will not fairly present financial position and results of operations in conformity with generally accepted accounting principles. Therefore, separate financial statements are needed. In determining the necessary statements, the underlying principles of fund accounting must be considered.

After determining the appropriate financial statements for the funds of a governmental unit, consideration must be given to the amount of detail in the statements. APB Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," suggests that "financial statements 'present fairly in conformity with generally accepted accounting principles' if . . . a proper balance has been achieved between the conflicting needs to disclose important aspects of financial position and results of operations in accordance with conventional concepts and to summarize the voluminous underlying data into a limited number of financial statement captions and supporting notes."⁶

With respect to the expenditures of a general fund, inclusion in the financial statement of each and every account in the general ledger would therefore be inappropriate; accordingly, summarization is necessary. However, judgment as to the proper degree of summarization may vary with respect to different functional classifications. For example, it may be appropriate to detail general government expenditures by functions, activities, and objects of expenditure while other functional classifications are shown only in total. This type of judgment, as well as judgments with respect to all of the individual statements, should be made in light of materiality in relation to each fund, group of funds, or account group included in the respective financial statements.

The individual balance sheets of the respective funds may be presented in a combined balance sheet. In governmental financial statements, a combined balance sheet is a single state-

⁶ APB Statement No. 4, p. 91.

ment that displays the separate balance sheets of individual funds, groups of funds, or account groups of a governmental unit in separate, adjacent columns.

A combined balance sheet may have a total column, which aggregates the amounts from all funds and account groups. If such a total column is shown, it should be captioned "Memorandum Only." The total column on a combined balance sheet is not comparable to a consolidation; it does not fairly present financial position in conformity with generally accepted accounting principles, even if interfund eliminations were made. It is not customary to make such eliminations in the combined balance sheet of a governmental unit.

A combined balance sheet may present a consolidation of nonhomogeneous funds, such as two or more nonrelated enterprise funds. While this may be done for presentation purposes, if nonhomogeneous funds are consolidated, separate balance sheets of the respective funds would be required in addition to the combined balance sheet in order for financial position to be presented fairly in conformity with generally accepted accounting principles.

Combined statements of revenues and expenditures of general and special revenue funds may be presented since the revenue and expenditure items are normally of a homogeneous nature.

Professional Pronouncements

Discussion of more specific accounting principles applicable to financial statements of governmental units are contained in Chapter 6, "Presentation of Financial Statements." Further, an analysis of professional pronouncements existing at the time of writing this audit guide has been made and comments as to applicability have been included in Appendix B.

Chapter 3

Budgeting Practices and Procedures

Background

To properly perform an audit of a governmental unit, it is desirable for the independent auditor to understand the historical concepts of budgeting as well as current budgeting practices and procedures of governmental units.

The term “budget” arises from the obscurity of the Middle Ages. Its earliest derivation appears traceable to Great Britain, the roots of its budget system being found in the emergence of parliamentary control over the crown in the Magna Carta of 1215, which provided that no taxes be imposed “unless by the common council of the realm.” Attempts at control over appropriations came as early as 1344 when Parliament demanded of the king that the money granted to him should be spent for the purposes for which it had been asked. But the power to control expenditures by means of annual appropriations was not regularly exercised by Parliament until the end of the 17th century. In 1787 another important element was added to the development of the budget process by the passage of the Consolidated Fund Act, which provided for the *general fund* to receive and record all revenues and expenditures. By 1802 an annual statement of public finances was prepared but this was not regularly transmitted to Parliament for its guidance until 1822.

Budgeting in the United States was built upon the foundations of practice and procedure developed in Great Britain. Abuses in public spending at the federal level and in many growing American cities over many decades brought frequent public demands for reform. By the early 1900's budget reform and the reorganization of city government usually went hand-in-hand with the efforts to improve the financial practices of the cities. By the mid-1920's most major American cities had undergone a more or less thorough reform in municipal financial practice and had established some sort of budget system.

The practice of budgeting spread, abetted by the passage of laws in virtually all states requiring adoption of budgets by states and most political subdivisions for at least those funds financed by and serving the general public. Historically these activities have been accounted for in the general fund of states and local governmental units. In many states laws have been passed earmarking special taxes to be spent for particular purposes, further requiring that they be accounted for in special revenue funds. Normally, these would also be for purposes serving the broad public interest, frequently financed by specified property or similar taxes.

These historical trends in the development of budgeting have been paralleled by improvements in accounting and financial reporting in the United States. There are very few states, if any, that do not currently require by statute that political subdivisions of any size or consequence both adopt and report budget comparisons with actual expenditures of at least the general fund; frequently state laws also require budgets to be adopted and reported on for special revenue and debt service funds, and sometimes for other funds of local governmental units.

Governmental units, however small, have at least a general fund. And although adoption of budgets may not be required by law, such units have an obligation of accountability to the general public which finances the activities of that fund.

These units should, therefore, adopt a formal budget and report a comparison of actual revenues and expenditures therewith. It is clearly inherent in government that a predetermined standard against which financial performance can be measured should be established for at least those governmental activities that serve

and are financed by the broad general public. These activities are normally accounted for in, and the operating results compared with, the budget of the general fund of each governmental unit.

These efforts to expand the practice of budgeting, as well as to improve the quality of accounting and financial reporting, have been abetted by the continued encouragement of the leading governmental associations in the United States.

Definition and Description of Budgets

The following discussion from GAAFR should provide a helpful review:

Defined in its most general sense, a budget is a plan of financial operation embodying an estimate of proposed expenditures for a given period of time and the proposed means of financing them. In contemporary public financial administration, there are two types of budgets: long-term budgets and annual budgets. The first of these represents estimates of public expenditures for a period of several years . . . and the proposed means of financing such expenditures. Frequently, such a long-term budget is restricted to major capital outlays only, in which case it is referred to as a capital improvement program or capital budget. The second type of budget, sometimes referred to as the current operating budget because it authorizes and controls current financial operations, is the annual budget applicable to each fiscal year. It is the latter budget which the Committee recommends for adoption, whether required by law or not, and which should be integrated with the accounting system to provide a workable system of budgetary accounting and control. . . .

The annual budgetary process involves three steps: preparation, adoption, and execution. The preparation phase of the budgetary process is usually a responsibility of the chief executive and is accomplished by the correlation of financial data produced by the accounting system and the projected program requirements of the various functions and activities for which a particular government may have responsibility. A prominent development in budget preparation and presentation during recent years has been the program or performance budget wherein expenditures are based upon activity performance rather than being based exclusively on character and object of expenditure. Regardless of the type of budget which may be used, however, the annual budget is presented to the governmental unit's legislative body for consideration, possible modification, and final enactment. With respect to revenues, enactment into law requires the adoption of appropriate tax statutes or ordinances in the

case of annually-levied taxes such as the property tax. Unless rates or substantive provisions are to be changed, no further action is required by the legislative body for such permanently-levied revenues as sales taxes, income taxes, and licenses. The expenditure side of the budget is enacted into law through the passage of an appropriation act or ordinance. The appropriations included in such an act constitute maximum authorizations to spend during the fiscal year, and cannot be exceeded except by subsequent amendment of the budget by the legislative body. Appropriations which are unspent at the end of a fiscal year may lapse or may continue in effect until they are spent in a subsequent period, depending upon laws applicable to the governmental jurisdiction. . . .”¹

Where the budget is integrated into the accounting system, general ledger control accounts as well as various detail subsidiary ledgers for estimated revenues and appropriations are set up. Record keeping for budgetary accounts is discussed in GAAFR.

In some cases the budget is not recorded in the general ledger and subsidiary appropriation ledgers are not established. Even though the budget is not formally recorded, the governmental unit needs to maintain adequate records if applicable accounting and legal compliance is to be demonstrated and the proper financial reports prepared. As a minimum, effective operating control would require the maintenance of records showing actual and accrued expenditures and, where encumbrance accounting is required, records of purchase orders and other commitments, to insure that budgetary authority is not exceeded.

Types of Budgets and Funds to Which Applied

There are two types of budgets commonly used, annual or operating and capital budgets. Operating budgets are applicable to general and special revenue funds and, where specifically adopted, debt service funds. Some jurisdictions require that an operating budget must be adopted (usually annually, but in the case of states, sometimes biennially) for all funds. Absent such a requirement or unless the nature of financing suggests otherwise (such as “pay as you go” financing), the capital budget (covering the expected life of the project) will be more

¹ GAAFR, pp. 5 and 6.

appropriate for a capital projects fund than an annual operating budget. Unless required by state or local law or ordinances, budgets normally are not adopted for special assessment funds.

Methods of Budgeting

In GAAFR Appendix A, "Terminology," three basic methods of budgeting are defined as follows:

Traditional Budget. A term sometimes applied to the budget of a governmental unit wherein expenditures are based entirely or primarily on objects of expenditure.

Program Budget. A budget wherein expenditures are based primarily on programs of work and secondarily on character and object. A program budget is a transitional type of budget between the traditional character and object budget, on the one hand, and the performance budget, on the other.

Performance Budget. A budget wherein expenditures are based primarily upon measurable performance of activities and work programs. A performance budget may also incorporate other bases of expenditure classification, such as character and object, but these are given a subordinate status to activity performance.

The traditional budget emphasizes the planned input of resources into a given organizational unit for particular objects of expenditure, such as salaries, supplies, equipment, maintenance, etc. In its present form it is oriented to the organizational structure for the primary purpose of imposing accounting and administrative responsibility upon department or division heads who expend appropriated funds. Without modification, it will not measure total expenditures for specific services, functions, or activities.

The traditional budget is a legal financial plan which involves an estimate of the revenue needs; the planning of spending requirements (which would justify the raising of revenue); legal action, by tax levy ordinance or otherwise, to fulfill these requirements—generally by funds, followed by the legal action of appropriation, again by funds. Generally, original planning is performed by the executive branch, but the final budget is a legislative enactment.

It is not unusual for last year's documents and the prior year's figures to be used as the pattern. Generally, on the appropriation side, classification will follow the categories in GAAFR's

Principle No. 11, by fund, function, organizational unit, activity, character, and object. Following is a discussion of the purpose and description of the typical program and performance budgets.

The Program Budget Approach does not emphasize the input of resources into organizational units but instead endeavors to measure the total cost of a specific function or activity that comprises a "program," regardless of the number of organizational units that may be involved in executing the program. The chief advantage of this approach is that it makes it easier for those analyzing a budget to grasp the relative emphasis being given to a particular program as compared to other programs, regardless of the number of units it affects. However, a shortcoming of this approach is that, by focusing on programs rather than units, it may fail to present with enough clarity certain types of data needed to form judgments on specific operations within the program, particularly when expenditures are being increased.

The Performance Budget Approach seeks to present a clear relationship between the input of resources and the output of service. To accomplish this objective, it lays principal emphasis on the measurement of quantitative data concerning units of work performed or services rendered within organizational units (departments) in performance of part or all of a given function or activity, e.g., number of tons of waste collected by the department of sanitation or case work load in the department of welfare. These "performance data" are used annually in the preparation of the budget as the basis for increasing or decreasing the number of personnel and the related operating expenses of a given department required to perform the services it renders.

The development of a full-scale performance budget, however, requires a strong budget staff, constructive participation at all levels, special accounting and reporting methods, and a substantial volume of processed statistical data. Primarily for these reasons, it has been less widely used than the traditional "character and object budget."²

In addition to the three basic methods of budgeting described, some state and local governments have begun to utilize the "Planning-Programming-Budget Systems" (PPBS) approach. PPBS attempts to apply concepts of program and performance budgeting to the tasks of identifying the fundamental objectives of a government; selections are made from among alternative

² Wixon, Kell, and Bedford, "Accountants' Handbook," 5th ed. (New York: Ronald Press Company), section 28, p. 15.

ways of attaining these objectives, on the basis of the full analysis of respective cost implications and expected benefit results of these alternatives.

While PPBS is somewhat similar to performance budgeting, it is distinguished by the fact that it adds a multi-year perspective, usually covering six years (as compared to the one-year framework of performance budgeting), and by its use of a systematic analysis of alternatives, which is not necessarily a characteristic of performance budgeting. It also takes into consideration all pertinent costs (capital, noncapital, direct, and associated support costs).

As might be expected, budget systems are often a combination of more than one of the three basic methods to obtain the advantages of different approaches. For example, a hybrid method may be used in which vouchers or supporting invoices are double-coded or otherwise dually identified so that they can be posted, first, to the traditional organizationally arranged budget accounts and, second, to program budget accounts. Expenditure statements showing comparisons with appropriations under both methods (with equivalent grand totals) could then be conveniently prepared for management. The first method would satisfy the requirement for stewardship and administrative control over department heads who expend appropriated funds. The second would measure the cost of programs undertaken by the governmental unit.

The Budget Process

The governmental unit is ordinarily required to follow a prescribed legal procedure in adopting the budget. This procedure would normally include adoption of a tentative budget by the governing body, posting of that budget for public inspection at a designated time and place and for a prescribed period, advertising of a public hearing, holding of the public hearing, final legislative adoption of the budget, and filing copies thereof with higher governmental agencies, such as a State Department of Municipal Supervision.

In addition, there may be specific requirements for amending an adopted budget. For example, to increase a previously adopted budget would, in most jurisdictions, require a supplemental appropriation, with much of the same formality required before

adoption of the original appropriation, including another public hearing. Also, specific requirements generally exist with respect to the authorization to increase, decrease, or transfer appropriations within or between budget categories or departments.

Budgeting Characteristics and Requirements by Funds

Budgeting requirements, if any, will generally differ among the eight different types of funds prescribed in GAAFR. Under GAAFR Principles Nos. 3 and 13, budgets would be required for all funds in order to be in conformity with generally accepted accounting principles; however, GAAFR does sanction some exceptions to its Principles Nos. 3 and 13. “. . . [The] principal exceptions to the use of budgetary accounting which the [NCGA] Committee sanctions are intragovernmental service and enterprise funds where demands for service and management flexibility outweigh the advantages of traditional budget control.”³ Also, GAAFR states that “with few exceptions, budgetary accounts . . . are not required for Trust and Agency Funds.”⁴

For financial reporting purposes, the statement of revenues and expenditures of the general fund and certain special revenue funds should include a comparison with a formal budget in order to be in conformity with generally accepted accounting principles.* However, this requirement does not extend to other funds within the eight different types of funds prescribed in GAAFR.

Special revenue funds requiring budget comparisons would include those funds used to account for amounts which comprise a substantial portion of the total governmental unit's expenditures and that are for a major governmental function. Such activities may be a part of the general fund in many states or, in some areas, may be performed by a special district, such as parks and recreation, sanitation, and streets and roads.

Apart from generally accepted accounting principles, budgets are often required for some or all funds by applicable laws. The following comments are offered relative to the use of budgets in all eight types of funds.

³ GAAFR, p. 5.

⁴ GAAFR, p. 75.

*AUTHOR'S NOTE: Prior to issuance of this guide, there have been no pronouncements by the AICPA concerning presentation of budget data in financial statements of governmental units.

The general fund and special revenue funds have annual budgets, each with its own estimated revenues and appropriations. Normally, the sources of revenues and the functions, activities, and objects of expenditure would be classified in the budget.

Special revenue funds require careful consideration because their revenues may have particular restrictions. For example, a motor fuel tax fund might require budgetary approval by the State agency which distributes the motor fuel tax revenue to the local unit.

Debt service funds normally originate by reason of a general obligation bond issue and will be governed by the terms of the issue. The two principal types of bond issues are serial bonds and term bonds, the former being more common. A debt service fund for serial bonds operates almost exactly like a special revenue fund. Term bonds, in contrast, may require accumulation of a sinking fund under specified conditions. There may be several debt service funds in existence at any one time. Typically, there will be a voter referendum approving the project and the related financing. The approved referendum would be implemented by a bond ordinance or resolution, which in effect results in a legal contract between the voters and the bond holders. Consequently, the financial needs for the entire life of the bond issue are provided for at the origin of the issue. As a result, the control factors inherent in an annual budget are satisfied by the terms of the bond resolution or ordinance. Including a budget comparison in the financial statements of a debt service fund provides little information or control, as there should be few variations between budgeted and actual expenditures because the budget for each year should conform with the terms of the indenture agreement.

Capital project funds account for resources appropriated for the construction or acquisition of fixed assets. Most governmental units maintain forward moving long-range plans of five or more years in advance. Such planning would give rise to annual authorizations for individual projects, which might be financed by bond issues, intergovernmental grants, or by other means. The project approvals would authorize expenditures not to exceed a given amount for the specific purpose, and would authorize the means of financing, subject to voter referendum or ap-

propriate legal action. These project approvals are then incorporated each year into the formal budgets of the individual unit. Generally, annual operating budgets are not legally required for capital project funds because most projects are not completed within one year. Capital project budgets (for the life of the project) are generally adopted. There may be more than one project in process at any one time, with the result that a separate budget for each project may be adopted; however, projects financed from the same source are usually combined in a single capital budget.

Where a unit utilizes recurring annual revenues to finance smaller capital improvements or projects, generally under a "pay as you go" financing program, the annual budget is more appropriate. Such a fund is also more appropriately titled "capital improvements fund."

For enterprise funds, legal requirements vary among jurisdictions as to use of formal budgets. The adoption of a budget providing for estimates of operating revenues and expenses is recommended as an aid to good management and sound financial planning. However, for purposes of achieving flexibility in management and financial planning, authorities generally recommend that such budgets be retained in memorandum form and not be subjected to formal budgetary accounting and control.

Intragovernmental service funds, such as central stores or central garages, perform services principally for the general and special revenue funds. Charges for such services are set at break-even levels as such funds are not intended to generate a profit. Normally, such funds will not have revenue and expense budgets unless required by law. One reason many jurisdictions do not require budgets for such funds is because the principal expenditures which such a fund can incur are limited by the direct appropriations of the various departments it serves.

If budgets are used for trust and agency funds, an annual budget is appropriate. An example of a trust fund for which a budget may be useful would be a public library given to a municipality by a private foundation that meets part of the library's operating costs, while the remainder is met by tax revenues.

Special assessment funds are used to finance and account for the construction and financing of certain public improvements

that are to be paid for wholly, or in part, from special assessments levied against benefited property. As stated earlier, unless required by state or local law or ordinances, budgets normally are not adopted for special assessment funds. However, where legally required, the project type budget is the more appropriate.

Legal Compliance

The independent auditor should be alert to any general or special features having to do with legal compliance relating to budgeting as applied to the eight different types of funds. Legal requirements should be observed in the adoption (including amendments), execution, and control of the budget.

Auditing of Governmental Units

Chapter 4

Audit Concepts

General

This section of the guide discusses concepts of auditing that are unique to governmental units. The reader of this guide is presumed to have knowledge and expertise in performing audits of commercial enterprises, which, accordingly, are not discussed here.

There is a similar objective in the audit of financial statements of a governmental unit or a commercial enterprise, namely, the expression of an opinion that the financial statements fairly present financial position and results of operations in conformity with generally accepted accounting principles. However, certain underlying differences in the nature of governmental units and commercial enterprises should be recognized in the performance of a governmental audit.

The primary purpose of a commercial enterprise is to produce a profit for its owners or shareholders, while that of a governmental body is to provide the services its citizens require within the framework of controls established by laws. A significant aspect of the governmental audit, therefore, is to ascertain whether, in obtaining and expending public funds, the unit has complied with the applicable statutes.

Despite certain differences underlying the reasons for governmental and commercial audits, generally accepted auditing standards are applicable in both situations. These are delineated in the ten standards set forth in Statement on Auditing Standards No. 1, "Codification of Auditing Standards and Procedures."

In both governmental and commercial audits the procedures appropriate for a particular type of account or transaction may differ from client to client, and even from year to year for a particular client, depending on a wide variety of factors—for example, the nature and extent of the applicable internal controls, auditing procedures performed for other accounts or transactions, the independent auditor's intuition, and even his judgmental preferences.

The audit discussions and related descriptions of audit procedures in this and the following chapter are intended to provide guidance to the independent auditor. The procedures are not intended to be all-inclusive. Neither is it intended that all of the procedures would be included in any given audit. The independent auditor should design each audit program so that it will be responsive to the circumstances of the particular engagement.

Fraud Detection

The responsibility of the independent auditor of a governmental unit to detect fraud is similar to that of the auditor of a commercial enterprise, the limitation of responsibility being clearly set forth in Statement on Auditing Standards No. 1, section 110.05. The independent audit is not primarily designed to disclose defalcations; however, an effective audit may minimize fraud loss and discourage irregularities; other fraud prevention or protection would include fidelity bond coverage, internal auditing, and, more importantly, an adequate accounting system with appropriate internal accounting controls. The lack of administrative continuity in governmental units because of continuing changes in elected legislative bodies and in administrative organization emphasizes the need for an effective internal control system.

Fraud or irregularities related to governmental operations normally are widely publicized by the news media. Hence, an auditor undertaking an engagement for a governmental unit should be prepared to accept the attendant publicity and questions relating to the scope and effectiveness of his audit procedures if his examination does not discover irregularities that exist and are disclosed publicly at a later date.

Financial Compliance Auditing

An aspect of governmental audits that requires special comment in this guide is the assessment of financial compliance with legal requirements.

Budgetary accounting is one important area requiring accountability for financial compliance. For example, disclosure should be made of a budget violation due to an unauthorized over-expenditure. In determining whether the budget in fact has been over-expended, it is necessary to determine whether applicable law requires adherence to line item appropriations or only to category appropriations or even total appropriations. Further, under governing law, an official may be personally liable for an illegal over-expenditure of appropriations. In this latter situation, the auditor should consider that the amount of the over-expenditure may be an account receivable rather than an over-expenditure.

Other examples of financial compliance auditing are (1) determining whether the proceeds of special taxes were recorded in the proper fund, and (2) determining whether cash receipts recorded as revenues in an enterprise fund having revenue bonds outstanding were accounted for in accordance with the terms of the bond indenture.

The independent auditor should seek competent legal counsel when there is a question concerning interpretation of applicable laws. However, interpretation of laws should not be confused with mere knowledge of law. It is necessary for the auditor to gain a working knowledge of applicable laws and to apply that knowledge in his auditing and reporting. If a legal interpretation is necessary but unavailable, a qualification in the auditor's report may be necessary.

Auditing for Program Compliance, Efficiency and Economy, and Program Results

Profound changes in our social, political, and economic order have brought steadily mounting demands from the citizenry for new and better public services. Response to these demands by governmental officials requires a process for policymaking, financing, and administration which frequently involves the joint cooperation of federal, state, and local governments. Thus, the system of government today rests on an elaborate structure of interlocking relationships among all levels of government—between executive and legislative branches of each level, between federal and state governments, and between both the federal and state governments and the local communities.

Accompanying this increased complexity in the relationship among the various levels of government has been an increased demand for information about government programs. Public officials, legislators, and the general public want to know not only whether governmental funds are handled properly but also whether specific programs are in compliance with existing laws and are being conducted efficiently, economically and effectively. This demand for information has widened the scope of governmental auditing.

The United States Government General Accounting Office (GAO) issued a publication in June 1972 entitled, "Standards for the Audit of Governmental Organizations, Programs, Activities, and Functions," which outlines standards for auditing program compliance, efficiency and economy, and program results. These GAO standards endorse the generally accepted auditing standards of the Institute, but provide for the following additional areas of audit coverage:

- *Compliance.* In addition to financial compliance, as discussed on page 37, the GAO standards include auditing for program compliance. As defined in this standard, program compliance involves following prescribed methods, observing specific timing, or performing certain prescribed activities.
- *Efficiency and economy.* Auditing for efficiency and economy involves determining (1) whether the entity is managing or utilizing its resources (personnel, property, space, and

so forth) in an efficient and economical manner and (2) the causes of any inefficiencies or uneconomical practices, including inadequacies in management information systems, administrative procedures, or organizational structure.

- *Program results.* Auditing for program results involves determining whether the desired results or benefits are being achieved, whether the objectives established by the legislature or other authorizing body are being met, and whether the organization has considered alternatives which might yield desired results at a lower cost.

An audit for program compliance, efficiency and economy, and program results, while complementary to financial auditing, is not included in the requirements for the financial audit. If an audit is to be conducted in these areas, specific arrangements for the engagement should be made, including an allowance for the additional costs involved.

As indicated previously, the GAO audit standards endorse generally accepted auditing standards adopted by the AICPA; however, certain differences do exist in the expression of the standards. If an auditor is engaged to conduct an audit in accordance with the GAO standards, he should be alert for differences in substance between such standards and the standards promulgated by the AICPA.

Some key provisions of the GAO standards are these:

1. No auditor is expected to give an opinion on how efficient or economical an organization is or whether program results have been effectively achieved. In such cases, the auditor reports what he finds factually and makes a recommendation for improvements he deems appropriate.
2. Where a determination of compliance with federal or state laws or regulations is a part of the audit scope, the appropriate federal or state agency is responsible for providing a guide setting forth those laws or regulations with which compliance is to be determined.
3. Where technical determinations (engineering, actuarial, etc.) are to be made, the auditor should engage competent technical help either by direct employment or on a consulting basis.

When an auditor reports on the results of a financial audit, he reports against the standard of generally accepted accounting principles. When he reports on an audit for efficiency and economy and program results, the auditor should carefully define the standard against which he is making his evaluation.¹

Some states have adopted or are contemplating adopting standards for operational or program audits. The concepts expressed above regarding GAO standards would also apply to such state standards.

Familiarization With Legal Requirements

The independent auditor should become familiar with the general laws and local ordinances applicable to the particular governmental unit being examined. This subject is more fully discussed in Chapter 5, "Auditing Procedures."

¹ For audits under GAO standards, the auditor should refer to the position paper issued by the AICPA Subcommittee on Relations with the General Accounting Office, "Auditing Standards Established by the GAO—Their Meaning and Significance for CPAs" (New York: AICPA, 1973).

Chapter 5

Auditing Procedures

General

This chapter discusses both general and specific audit procedures that may be appropriate in an audit of a governmental unit. As pointed out in Chapter 4, audit procedures appropriate for a particular type of account or transaction differ from client to client and even from year to year. The independent auditor should design the audit program for each governmental unit so as to be responsive to the circumstances of the particular engagement.

INTERNAL CONTROL

As in audits of commercial enterprises, generally accepted auditing standards require that the independent auditor study and evaluate the existing system of internal control as a basis for reliance thereon and determination of the extent of the applicable audit tests.

Statement on Auditing Standards No. 1, section 320, and related subsections 320a and 320b, are applicable in their entirety to audits of governmental units. The independent auditor

should refer to these sections for guidance in evaluating internal control for specific audit engagements.

One method of strengthening internal control is through the use of internal auditing. Many governmental units are able to support and justify the need for an internal audit function. The independent auditor can be helpful in identifying the scope of work that should be performed by an internal audit staff and can assist the client in effectively using internal audit personnel. Internal auditing, however, is not as prevalent as it should be in governmental units.

However, where there is an internal audit staff, the independent auditor may consider the extent of its examination in planning his audit program.

Preliminary Planning of the Audit

As with any audit, a governmental audit engagement requires planning. Such planning will include the consideration of matters common to all audits, such as engagement letters, type of financial report required, additional services to be performed, type of record keeping employed (manual or some form of automated system), and the accumulation of various documents which will be necessary for the audit. In addition, other matters commonly encountered in governmental units should be considered:

1. In governmental units, it is not unusual for accounting records to be maintained on one method of accounting during the year and converted to another method at year end. The most common situation of this type is the maintenance of accounting records on a cash basis during the year and conversion to the accrual or modified accrual method at year end.
2. Before accepting the engagement, the auditor should determine which financial statements of the governmental unit he is to audit. The engagement letter should specifically identify whether the auditor is to examine the financial statements of only certain of the funds, or whether the engagement is for the audit of the financial statements of all funds and account groups of the unit.

3. In the engagement letter, the independent auditor should consider including a statement of his responsibility to discover irregularities and to report such irregularities to any authority independent of any mention which might be made in his report. Further, certain government agencies may advocate use of a prescribed form of engagement letter which excludes any reference to the detection of fraud. In these cases, the auditor may wish to insist that the agreement letter be modified.
4. Other matters which may be of importance in the audit of a governmental unit and should be considered at a preliminary stage include the following:
 - (a) Special factors, such as a city utility having revenue bonds outstanding, recent construction programs, recent financial problems, etc.
 - (b) Relationships with other governmental units that may affect the audit.
 - (c) The current year's budget and the proposed budget for the next year, if available.
 - (d) Certain key ordinances, such as the tax levy ordinance, appropriation ordinance and ordinances related to outstanding bond issues, trust indentures, etc.
 - (e) The governmental unit's charter.
 - (f) Pertinent federal or state audit guides and grant agreements and regulations.

THE AUDIT PROGRAM

Audit programs for governmental units usually differ in certain respects from programs designed for examinations of commercial enterprises. The primary reason for such differences is that in audits of commercial enterprises generally only one entity is under examination, while in local government many entities (funds) usually are under examination. These individual funds have special fiscal characteristics peculiar to themselves. The audit program should give recognition to such features, in addi-

tion to emphasizing financial compliance with legal requirements.

Many funds of a governmental unit have similar assets and liabilities, for example, cash in bank, investments, property taxes receivable, accounts payable, etc. The audit may be more efficient if such accounts are examined and tested as one section of the audit program rather than separately for each fund. While the auditor should design his program to conform with the requirements of each fund, audit procedures (such as transaction tests) common to more than one fund may comprise a separate section of an overall program.

Many audit procedures are common to both governmental and commercial audits, having basic similarities in purpose and result. Such procedures, for example, are those for cash, receivables, investments, inventories (if applicable), accounts and vouchers payable, payroll and related taxes, notes and contracts payable, and, in part, fixed assets and purchases. As in the audit of a commercial enterprise, the auditor of a governmental unit must exercise his professional judgment as to the extent of such procedures in a given engagement. In making this judgment, the auditor should consider that he will be expressing an opinion on the separate financial statements of the various funds (or group of funds) and account groups, and not on those of the governmental unit as a whole. Accordingly, materiality should be determined in relation to each of the separate statements.

While all categories of governmental units are subject to independent audits, municipalities are the most frequently examined. The "general fund" is the major fund of a municipality with respect to both volume of financial activity and accountability. Accordingly, the examples of both general and specific audit procedures in this chapter are directed primarily toward examination of the financial statements of the general fund of a city, town, or village, although references are made to assets and liabilities usually appearing in other funds or account groups. The narrative descriptions of the major areas of application of audit procedures emphasize those that are significantly different from the procedures found in audits of commercial enterprises. The procedures described herein do not constitute an audit program; rather, they represent audit procedures that the independent auditor may consider in preparing his program for a specific engagement.

REPRESENTATION LETTERS

The independent auditor should consider obtaining a representation letter from the officials of the governmental unit whose financial statements he is auditing. Such a letter will differ from one ordinarily used for a commercial enterprise. Subjects which the auditor may consider including in a representation letter are as follows:

1. Identification of funds of the governmental unit, subject to the audit.
2. Accounting policies and principles applicable to individual funds or fund groups.
3. Inventory policies and valuation (if applicable).
4. Pledged assets.
5. The responsibility for recording of all liabilities.
6. The existence of any contingent liabilities and claims, contractual obligations, and other commitments.
7. Completeness of minutes presented for audit examination.
8. Knowledge of any subsequent events of a significant nature.

GENERAL AUDIT PROCEDURES

Familiarization With Legal Requirements

As set forth in Chapter 4, the importance of financial compliance with legal provisions in government requires the independent auditor to be familiar with the general statutes and local ordinances applicable to the particular governmental unit being examined and with the provisions of the charter or other document by which the unit acquired its power and right of existence. The unit's legal counsel is frequently the source of this information. In this review the independent auditor will be apprised of the geographical and political jurisdiction of the unit under audit, how it is organized, the duties and powers of the administrative officers, and other appropriate matters concerning the operations of the governmental unit.

The following types of laws, rules, and regulations pertaining to governmental units, if they exist, may have particular relevance to a given engagement:

1. Audit laws.
2. Provisions of state statutes applicable to finance, accounting, and auditing. (In some states the appropriate supervisory official may have had these extracted and published in booklet form.)
3. Bulletins or regulations issued by supervisory officials of the state, for example, by a state auditor.
4. The relevant ordinances of the governmental unit, including provisions relating to auditing.
5. If applicable, the laws and other regulations governing the use of grants made by the federal government.

Budgetary Control

One aspect with which the independent auditor must be concerned is budgetary control. The requirements under applicable law for the adoption of budgets for the individual funds of the governmental unit will have special significance. In addition, the auditor should review procedures relating to execution and control over the budgets as adopted. Further, the auditor will be interested as to whether and by what method the budgets may be revised or amended.

The auditor should determine the amounts which represent the final budget for the current fiscal year by examination of evidential matter as to approval of both the budget originally adopted and any subsequent revisions or changes. The appropriate source of such evidence is usually the minutes of meetings of the governing body.

After the auditor is satisfied as to the final budget amounts, these amounts should be compared with actual expenditures to determine whether the budget has been violated by over-expenditure. When making this comparison, the auditor should consider the detail to which the budget controls relate. For example, the budget may control each line item in which case it would constitute a violation if the amount of any one expenditure account exceeds the related amount in the budget.

On the other hand, the budget may control major categories of expenditures only. In this case, the amounts of individual accounts may properly exceed corresponding amounts included in detailed listings supporting a budgeted category amount so long as the total of actual amounts in the category does not exceed the budgeted amounts for the category. While such categories are normally functional classifications, they may represent other groupings, such as accounts for which a particular administrator is responsible. This information would be found in the laws or rules governing the appropriate budget function.

Reconciliation Between Offices

Governmental units often have specific requirements for reconciliation of transactions between certain offices such as between the offices of city treasurer, city auditor or comptroller, city clerk, etc. Reviewing such reconciliations of financial transactions should help to detect any irregularity or discrepancy between records maintained by various elected officials or operating departments.

State and Federal Audit Requirements

Local governmental units are normally subdivisions of the state and must operate under specific state laws and regulations. For example, a motor fuel tax fund in a county, city, village and/or township will typically be closely controlled by a state agency; commonly, all motor fuel tax programs and projects are approved in advance by the state agency. Local schools may be closely regulated by a department or agency. Programs financed with federal funds usually have special operating, accounting, reporting and auditing requirements. In some instances, the audit requirements of a federal or state regulatory agency may specify additional auditing procedures, for example, that the independent auditor shall ascertain whether an identifying label is affixed to all fixed assets acquired out of a particular grant; they may require a special form of report in addition to the independent auditor's opinion on financial statements, or a special audit report under separate cover with a different time period than the governmental unit's fiscal year.

The independent auditor's examination may require extension

to accommodate these special reporting responsibilities. Such extended procedures should be clearly covered by the provisions of the engagement letter with the client.

Reports by Supervisory Agencies

Federal or state agencies may conduct their own audits of grantees or units they supervise. Review of their audit reports may disclose special financial reporting implications; for example, disallowance of an expenditure may require a refund or result in a deduction from a subsequent grant.

Manuals

Guidance manuals have been developed and are available for use by state agencies, cities and villages, school districts, park districts, etc. Some state societies of CPAs have also prepared such manuals. If an authoritative manual is available, the review of legal provisions and administrative procedures may be materially expedited.

Review of Minutes of Meetings of a Governmental Unit

Minutes of meetings of the governing body are important to the independent auditor. Minutes should be reviewed and any items having a significant effect on the financial statements should be noted. If the auditor notes that important transactions or matters requiring approval by the governing body (whether under the charter, bylaws, or ordinances, or under established practice) are not covered in the minutes, such omissions should be called to the attention of the proper officials for appropriate action. If the matters involved have a material effect on the financial statements, and if appropriate corrective action is not taken, the auditor should consider what effect the matter will have on his report.

The following matters are generally recorded in minutes:

1. Budget approval, in terms of the appropriation ordinance or equivalent, and related tax levy action, together with any supplemental appropriations.
2. Ordinances and resolutions adopted (usually attached as exhibits or separately filed).

3. Salary rates and changes.
4. Major personnel appointments.
5. Classes and numbers of licenses within each class; approvals and revocations thereof.
6. Motor fuel tax resolutions.
7. Bond issue resolutions.
8. Approval of tax anticipation borrowing.
9. Advertising for bids on contracts and acceptance thereof.
10. Special assessment projects and related ordinances and tax levies.
11. Transfers or loans between funds.
12. Grant applications.
13. Sale and purchase of property.
14. Notices of public hearings and resulting decisions.

Some governmental units register and control ordinances and resolutions by numerical coding in chronological order. Others may maintain a numerical code (or its equivalent) by code and section number into which new or revised ordinances are incorporated.

Bond issue resolutions and related bond indentures are particularly important. The minutes of the governmental unit will ordinarily include a full history of the projects from the initial planning stages: approval by the governing unit and possibly boards or committees; authorization of a referendum; canvass of the votes; advertising for bids; acceptance of bids on the project; acceptance of bids on the bonds; sale of the bonds; approval of a paying agent; special funding, etc.

The above information on bond issues would be relevant to the independent auditor's examination of transactions in capital projects, special assessment, and debt service funds, and the general fixed assets and long-term debt groups of accounts. (If a bond issue is in prospect, joint participation of the unit's independent auditor and its legal counsel in drafting the accounting provisions of the bond issue ordinance has in many instances been helpful in conforming legal and accounting requirements.)

The minutes of most governmental units are detailed and

lengthy. In order for the auditor to review them most effectively, he may suggest that the client provide copies for the auditor's files.

AUDIT PROCEDURES FOR SPECIFIC ACCOUNTS

As discussed in Chapter 4 and reiterated earlier in this chapter, the specific audit procedures set forth herein are not intended to be followed in every audit nor to be all-inclusive. Rather, they represent audit procedures that each independent auditor may consider in preparing his programs for a specific engagement. As in any audit engagement, materiality and the effectiveness of internal controls will be important factors in designing the audit program.

Revenues and Other Receipts

Collection of cash is likely to be decentralized. Normally, the treasurer (or other designated official) will be the principal collector. Frequently, however, there will be numerous other collection points: for example, a city engineer's office may collect the fees for building permits; fines may be paid to one or all of several different courts in a city; parking meter receipts may be collected directly from parking meters, while monthly payments for parking space rentals may be paid by check to the city department in charge of public property; deposits with the city treasurer from each of these sources may or may not be required. Taking into consideration the diverse sources and relative significance of each type of revenue, the auditor should test the various sources of such receipts. Such tests should take into consideration any requirement for legal compliance inherent in governmental units.

Revenue of a general fund for a typical municipality is derived primarily from the following sources: (a) taxes, (b) licenses, fees and permits, (c) intergovernmental revenue, (d) charges for services, (e) fines and forfeitures, and (f) miscellaneous revenue, including interest earned on investments, rentals of property and equipment, and contributions from other funds.

The auditor should especially consider testing of revenue

which should have been received against revenue recorded as actually received. For this purpose, the auditor should review the internal accounting controls over the collection, flow, and custody of receipts, and consider the possibility of unrecorded receipts at collection points. Because municipalities have numerous funds and bank accounts and receive or collect monies in various ways, audit programs for tests of revenue areas should be appropriately designed for each engagement. Audit procedures which the auditor may consider for revenue sources follow.

Taxes. A discussion of accounting procedures normally followed in accounting for various tax revenues and suggested audit procedures for the independent auditor to consider follow.

General property taxes—The property assessment, levy and collection procedure varies among the different states. In many states, the county undertakes the entire process and remits collections to the various taxing bodies within its jurisdiction. In other states, the municipality has the authority to assess, levy and collect its own property taxes. Accordingly, auditing procedures should be designed to accommodate the specific taxing procedures of the governmental unit under examination.

Where another governmental unit collects the property tax, the independent auditor should review the procedures to establish the propriety of the tax revenues so reported. He may elect to confirm with, or inspect, the other unit's records to determine, by fund, (1) the total assessed valuation, (2) the collections by year of levy, (3) the charges for assessment, extension, and collection, and (4) the balance of uncollected property taxes. Such amounts can then be traced to the records of the unit being examined to determine whether taxes due have been properly accounted for and taxes collected have been correctly applied to the respective funds.

Where the municipality assesses, levies, and collects its own property taxes, the auditor should consider a review of the entire procedure for the current year's levy and should make appropriate tests of the assessments, tax billings, collections and receivables. With respect to the assessment area, the auditor may test assessment procedures, including controls over changes, but is not responsible for evaluating values at which properties are assessed.

Where the unit under audit has the responsibility for foreclosure and sale, the auditor should consider reviewing finalized court decrees vesting title in the governmental unit and subsequent sales of the properties. The authorizing statutes or ordinances should indicate the proper funds or other taxing units to which the proceeds of sales of foreclosed properties should be credited.

Self-assessed taxes—Many governmental units have locally imposed self-assessed taxes, such as gross receipts, franchise, sales, income and payroll taxes. The auditor should consider making tests of revenue against the tax returns filed. If accounting controls over the returns and related revenue may be relied upon, additional audit procedures may not be required. If such controls are inadequate, the auditor should consider additional tests; for example, a number of taxpayers may be selected at random (business establishments located in one or more city blocks, telephone directory listings, newspaper advertisements, etc.) and the names of such taxpayers traced to the records of the governmental unit.

The independent auditor is not required to audit the tax returns; however, the internal audit staff of the governmental unit should conduct field audits of such returns. The independent auditor may conduct these audits at the unit's request with the understanding that such audits would comprise a separate engagement.

Licenses, Fees, and Permits. As listed on page 49, ordinances (and revisions thereto) relating to licenses, fees, and permits will be included in minutes of meetings of the governing body. The reasonableness of the gross revenue may be established by relating the fees to the various classes and number of licenses and permits issued. The reasonableness of the number of licenses and permits issued by classes may be established by reference to prenumbered forms or other supporting information.

In addition, the independent auditor should consider testing licenses issued to determine whether fees charged were in accordance with the appropriate ordinance fee schedule and that revenues have been recorded in the proper accounts.

Intergovernmental Revenue. Certain revenues obtained from other governmental units are generally not under the control of municipalities. Such revenue as sales tax distributions, income tax distributions, motor fuel tax allocations, etc., usually is distributed to the municipality by the state. Consideration should be given to confirming such revenue and receipts with the appropriate department of the state government. The auditor should also consider testing whether such revenue was recorded in the proper funds of the municipality.

Grants, subsidies, and locally shared revenue obtained from either the county, state, or federal government may also be confirmed with the distributing agency and traced to the records of the municipality under examination. Difficulties may be encountered in obtaining confirmation from federal and other agencies; nevertheless, such procedures should be implemented, with care exercised in directing confirmations to the appropriate officials. If confirmation is not possible, alternative procedures should be considered.

Charges for Services. Included in charges for services are departmental fees of all kinds. Normally there are one or more collection points in each department. The amount of such revenue can usually be evaluated for reasonableness. If any of the revenues are significant to the fund being audited, appropriate tests should be made.

Two related forms of revenue—parking lot and parking meter receipts—present special audit problems. The auditor can review the controls over such receipts to determine whether they may be relied upon. In the case of “monthly stall parking,” the reasonableness of revenues may be determined by relating number of stalls to fees per stall, allowing for average stall vacancy, if any. In the absence of controls upon which he can rely or some other method of determining the reasonableness of revenues, the auditor should report a restriction in the scope of his examination and limit his opinion to recorded revenues.

Fines and Forfeitures. The accounting for arrest tickets can be tested to determine whether the tickets are being properly disposed of through the collection of cash or authorized dismissal. This test can cover the prenumbering control and the revenue

shown in the court docket as compared to the general ledger revenue account.

Miscellaneous. This revenue group includes all general fund revenues not otherwise classified, including principally interest income, rents and royalties, and contributions from enterprise funds. In many municipalities, significant amounts are separately classified in the ledger and in financial reports.

Interest earned on investments can be tested through the use of normal audit procedures. The auditor should be alert, however, to whether the interest was applied to the proper fund of ownership, except where local ordinances or state statutes require or permit distribution to other funds.

With respect to rentals of property and equipment, the auditor should review copies of lease contracts, schedules, and other documents covering the use of municipal property by others. The amounts of rents, royalties, or concessions due can be computed and compared with revenue recorded in the general ledger.

Proceeds From Sale of Bond Issues. The proceeds from sale of bonds (other than special assessment or utility bonds) are recorded in a capital projects fund and constitute a revenue of such fund. The auditor should examine selected documents relating to the sale of bonds, such as the bond ordinance or resolution, bid notice and bids submitted, and settlement statement. The net cash proceeds can be traced to the settlement statement and to the bank account of the specific capital projects fund. For more effective control over the proceeds of bond issues, many municipalities require a separate bank account. The auditor may also want to test for the proper recording of bond premium, bond discount, and accrued interest received, where applicable. Many bond ordinances provide that accrued interest received on bonds sold subsequent to the issue date of the bonds shall be transferred immediately to the related debt service fund.

Expenditures and Other Disbursements

Appropriations and Encumbrances. A copy of the official appropriation ordinance and copies of appropriation transfer reso-

lutions, if any, should be made available to the independent auditor.

The estimated revenue and appropriation amounts should be shown in the financial statements for comparison to actual revenues and expenditures of each fund for which a budget is required. In this respect, the auditor will be interested in the actual expenditures (plus encumbrances if applicable) as compared to the authorized appropriation limits in the budget. (See discussion on pages 46 and 47.)

Encumbrances are unique to governmental accounting in that outstanding commitments or bona fide purchase orders can be charged to appropriate line items. The auditor should consider testing whether expenditures arising from the prior year's encumbrances were charged against the related encumbrances outstanding account. He may also test the validity of the current period's encumbrances by reference to contracts, purchase orders, and minutes of the governing body. An examination of payments subsequent to financial statement date and their related encumbrance date will help establish the reasonableness of the encumbrance account as of the end of the period under examination.

Purchases. In many jurisdictions there are prescribed purchasing procedures relating to bids, contracts, etc. Most of these indicate a dollar range or amount in excess of which competitive bids are required in all instances. The auditor should be aware that situations may exist where purchase orders are reduced below these amounts to circumvent the required competitive bidding procedures. The auditor should also review statutory bid requirements and consider testing whether expenditures were made in accordance with such procedures.

In addition, even though invoices may be approved before payment by a finance committee or the governing body itself, the independent auditor should consider testing whether quantities, extensions, prices, etc., are being properly verified. Where applicable, tests may be made to determine that exemptions from sales taxes, federal excise, and other taxes are being claimed.

Payrolls. Personnel service costs of the average municipality represent a substantial portion of the annual expenditures. Be-

cause of their materiality, the auditor should give payroll costs careful attention.

In addition to normal audit procedures applicable to payrolls, the auditor should consider testing salary rates and fees paid to determine whether they comply with authorization of the governing body and whether they satisfy the provisions of applicable ordinances, union contracts, or federal laws or regulations, such as the Davis-Bacon Act. In addition, the control over hiring of new employees, sickness and vacation authorization, terminations, etc., may be reviewed and, where appropriate, tested by the auditor. In certain situations the auditor may decide to observe a payroll distribution on an unannounced basis, properly identifying each employee by obtaining signatures for comparison to personnel files or by other means.

Expenditures Other Than Purchases and Payrolls. The audit procedures with respect to expenditures other than purchases and payrolls should be the same as those customarily followed in the audit of commercial enterprises. In addition, the auditor should consider tracing selected large expenditures to the minutes of the governing body for approval, price, terms, etc. Examination of travel expenditures requires special consideration and is commented on below.

Travel—In certain jurisdictions, specific employees may be required to travel in the performance of their assigned duties and responsibilities. Frequently, specific travel regulations exist that outline the travel costs that are reimbursable. To determine whether control is being exercised through proper review and authorization by supervisory personnel of travel reimbursement requests, the auditor should consider testing the reasonableness of travel reimbursements claimed.

Other Disbursements. Other transactions, such as payment of bond principal and interest, construction costs, repayment of customers' deposits, etc., should be considered for testing by the auditor to satisfy himself regarding documentary support and application to the correct funds.

With respect to disbursements under private contracts or government grants, the auditor should inquire as to the extent of

the municipality's participation in projects for, or with, governmental agencies and private entities. For this type of activity, administrative policies should be reviewed with respect to budgeting, costing procedures, overhead allowances, billing procedures, collection or prepayment policies, and other compliance procedures. Unbilled costs and/or uncollected billings may be traced, where appropriate, to the receivable ledgers and underlying data.

The audit requirements applicable to some federal and state grants differ substantially from those employed in the usual audit of a governmental unit. In order to avoid misunderstanding, the auditor should reach an advance agreement with the unit as to the scope of his engagement with respect to federal and state grants or subsidies. The funding agency may have issued audit guidelines on the applicable grant for use by the independent auditor.

In situations where the governmental unit provides welfare assistance to needy persons or families, the auditor should consider testing case files for documentation regarding the welfare recipient's entitlement. Signature endorsements on the cancelled checks or warrants could be tested against signatures on the recipient's application for aid. The auditor should consider the propriety of the payment where there are unusual or suspicious second endorsements.

Assets

Cash Funds. It is not unusual to find cash funds of one type or another not recorded by the governmental unit. The independent auditor should evaluate whether accounting controls are adequately established and custodianship assigned to responsible officials for cash funds. Where they are not recorded, the auditor should consider recommending that they be recorded.

In some cases, the auditor may encounter a situation where funds of the governmental unit have been commingled with those of an elected official or administrative head. Where this condition exists, the auditor should consider the possible illegality thereof and the extension of his procedures to test accountability for the governmental unit's transactions.

The auditor should be informed as to location of general cash, imprest cash, and undeposited receipts and securities. He should

consider which funds should be counted simultaneously and decide if it is necessary to reconcile bank accounts and inspect securities at the same time that the cash is counted. Inquiry should be made to determine of any cash funds, such as "Volunteer Firemen's Fund," "Employees' Benevolent Fund," etc., are maintained by employees apart from the municipal records. In such cases, further inquiry might be made of the unit's legal counsel as to the accountability and reporting status of such cash funds.

In many municipalities, merged bank accounts are used as a depository for several funds. When performing his examination of cash, the auditor should consider the accountability, by fund, for such deposits. He should also consider whether, by law, deposits are required to be maintained in separate bank accounts.

If required by a law affecting the unit under examination, or the unit's policy, confirmation should be considered to determine whether bank accounts are secured by adequate collateral by the depository when the balances exceed the amounts insured by the applicable federal agency.

Transfers between bank accounts and funds before and after the close of the period under review should be tabulated. Discrepancies and abnormal items should be investigated.

If a safe deposit box is maintained by the municipality, the auditor should consider examination of its contents in the presence of authorized officials.

Investments. City and state treasurers maintain custody over negotiable instruments that comprise investments of the governmental unit. In addition, numerous governmental units maintain custody of negotiable securities placed on deposit by various contractors, licensees, vendors, etc. The independent auditor should include both types of investments in his audit program.

In addition to possible physical inspection or confirmation of investment securities as of the examination date, the auditor should consider whether investments comply with statutory authorization. Generally, governmental units are restricted as to the type of investment securities they may hold.

Receivables. A discussion of audit procedures to be considered for various types of receivables follows.

Property taxes receivable—Generally, the audit of property taxes receivable can be most efficiently performed if correlated with the audit of property tax revenue (see pages 51 and 52).

Where the unit being examined does not collect taxes from the property owners, the auditor will usually confirm with the appropriate agency the amount of taxes receivable by year of levy. In auditing a unit which collects its taxes from the property owner, the auditor faces a different problem. Normally, it is not practicable to confirm taxes receivable with property owners. In such situations, the scope of the auditor's tests of procedures and other documentation should be designed to compensate for the lack of confirmation. The auditor's procedures could include a test of subsequent collections and a comparison of trends in delinquency.

The auditor should evaluate the need for an allowance for uncollectible property taxes. In making this evaluation, he should consider the effect of possible tax foreclosures.

Interfund accounts—Transactions between funds for the purpose of charging for services or accommodation purchases to be paid for by the benefited fund at a later date are quite common. The independent auditor may review these transactions for (1) propriety, (2) method or terms of repayment, and (3) current status or age of balances. In addition, the auditor may request from client personnel, or prepare himself, a reconciliation of the various balances between funds to determine whether the "receivables" are in agreement with the "payables."

Other than analysis and tracing to ascertain that balances are reciprocal, interfund transactions do not involve difficult auditing problems; however, they may involve accounting and reporting problems. See "Fund Accounting," and "Interfund Transactions" (pages 9-12) for a description of appropriate accounting treatment of such transactions.

Receivables from other governmental agencies—In addition to confirmation procedures, the auditor should consider reviewing underlying documents supporting the governmental unit's right to such amounts.

Miscellaneous receivables—In certain instances, the auditor may determine that control over "miscellaneous" receivables is

inadequate; e.g., receivables for projects such as sidewalk replacement, tree removal, etc., may be recorded on an informal basis. As a result, the amounts due the municipality are not always controlled and recorded as accurately as they should be. The independent auditor should consider confirming recorded amounts of miscellaneous receivables and consider the possibility that some receivables have not been recorded.

Inventories. Customarily, audit procedures for inventories are applicable to audits of governmental units. However, governmental units frequently do not record inventories, particularly in nonenterprise funds. Thus, the auditor will need to be alert for the possibility of recordable inventories where there is no apparent indication that they exist.

Property, Plant, and Equipment. Utility plant in service, general fixed assets, or other property, plant, and equipment in governmental funds should be audited in the same manner as for commercial enterprises, including tests of depreciation computations where applicable.

Where the dollar amount of the acquisition of such assets requires approval of the governing body and the use of bid procedures, the auditor should consider testing for compliance with such requirements.

Many federal grants permit the purchase of nonexpendable property. The provisions of such grants relating to identification and disposition of assets should be considered by the auditor in preparation of audit procedures for assets so acquired.

Other Assets. Prepaid expenses and deferred charges usually are not recorded under the modified accrual basis of accounting, as applied to budgetary funds. However, where such items are appropriate, the auditor should evaluate the reasonableness of the allocation of the charges.

The separate accounts "amount available for the payment of general obligation bonds" and "amount to be provided for the payment of general obligation bonds," respectively, arise from noncash entries in the long-term debt group of accounts. The offsetting credit or liability represents the total principal amount of general obligation bonds to be retired in future years. The

account “amount to be provided for payment of other long-term liabilities” is frequently used to identify the source of payment for liabilities other than general obligation bonds. Since these accounts represent only balancing amounts, no audit procedures are applicable.

Liabilities

Accounts and Vouchers Payable. Auditing procedures applicable to this area of fiscal accountability are identical to procedures employed for commercial enterprises. However, the auditor should be alert to determine whether the payables are properly classified by funds.

Tax Anticipation Notes or Warrants. Most local governments have statutory authority to obligate tax levies through the sale of interest-bearing tax anticipation notes or warrants, generally not in excess of 75 percent of the levy. Normally they must be redeemed from the first property tax collections of the specific levy under which the notes or warrants were sold although, in some jurisdictions, fixed maturity dates may be permissible. The independent auditor should consider whether unpaid amounts should have been paid from taxes already collected and should further consider confirmation of unpaid amounts with the holder or holders thereof.

General Long-Term Debt. General long-term debt consists primarily of outstanding general obligation bonds at the balance sheet date. It also includes notes, contracts, or other obligations with maturity dates beyond one year from date of issuance. Some suggested audit procedures are set forth under the sub-captions that follow.

Bonds Payable—A schedule of debt service charges to maturity of all general obligation bonds outstanding, showing the maturity dates and amounts of bond principal and interest payments due annually on each issue will serve as a convenient checklist for the auditor in examination of redeemed bonds and coupons. Cancelled bonds and coupons or properly approved cremation certificates should be tested.

General obligation bonds are normally paid from general property taxes levied on all property in the unit. Accordingly, each year's tax levy is made for the retirement of specific bonds and interest. As a part of the property tax audit procedure, the independent auditor should review whether the proper amounts of property tax revenue have been applied to the appropriate debt service funds and whether disbursements therefrom have been made for bond principal and interest or other authorized purposes, such as paying agents' fees and cost of assessing and collecting taxes.

Revenue bonds are normally applicable only to enterprise funds. Redemption of such bonds and payment of interest are normally made from earnings of the enterprise. (See pages 65-67 for a discussion of revenue bonds and related audit procedures.) If general obligation bonds are repaid from an enterprise fund, the disbursements therefor may be made direct, or transfers may be made to a debt service fund for such purpose. The audit procedures applicable thereto are identical in either circumstance.

Sinking fund requirements on term bonds—The bond ordinances will usually specify amounts to be set aside for the retirement of term debt. Sometimes, however, the provisions of the ordinance will be less specific and will, in effect, leave the determination of sinking fund requirements and other provisions, if any, to the discretion of the governing body. The auditor should review such transactions to evaluate whether the governmental unit has complied with the applicable provisions.

Installment purchases—Some jurisdictions permit installment purchases by governmental units. Where such purchase arrangements exist, the auditor should review laws regarding such contracts and, as a part of his audit procedure, consider confirmation of the unpaid balance and interest charges and ascertain that, where applicable, the balance is included in the long-term debt group of accounts.

Other Liabilities. Municipalities generally require certain deposits to be made by citizens or contractors for various purposes, such as street opening deposits, water and sewer billing deposits,

etc. Such deposits are to insure completion of a service or are “good faith” deposits and normally are refundable. Accordingly, the amounts deposited are not an asset of the municipality, but represent a liability to the depositors. The auditor should review deposit details for proper segregation and agreement with general ledger control accounts. In addition, the auditor should consider reviewing the composition of the deposit account and investigate large, irregular, old, or inactive items.

Other liabilities may consist of judgments, taxes collected in advance, sundry payables, etc. The auditor should consider reviewing such items by reference to underlying documents or transactions during the year.

As in any audit, there should be a search for unrecorded liabilities. If the encumbrance method is used, the search should include a search for unrecorded encumbrances.

Fund Balances and Other Equity Accounts

The fund balance or equity of a given fund in a governmental unit may have subclassifications, each having a separate and distinct characteristic or function. Typical subclassifications are discussed briefly, as follows:

Appropriated. In those jurisdictions that require continuing reappropriation of the fund balance in the general fund, the portion thereof appropriated in the succeeding year’s budget should appear in the balance sheet under this caption even though no segregation may have been made on the books, in order to reflect the legal restriction thereon.

Unappropriated. The unappropriated portion of fund balance is available for future budget financing and in most jurisdictions is not restricted as to use. An analysis of changes in the account should be made for the year under examination, and charges and credits to the account should be reviewed for propriety. Generally, such analysis would include the appropriated portion, as described under the preceding caption.

Retained Earnings. Such balances are applicable to enterprise and intragovernmental service funds and represent accumulated

earnings, similar to commercial enterprises. An analysis of changes therein during the year should be reviewed for propriety.

Investment in General Fixed Assets. This form of equity represents the source from which general fixed assets were acquired, such as current revenues in general or special revenue funds, general obligation bond issues, or contributions, etc. An analysis of changes in each of such sources for the year under examination should be reviewed for propriety by tracing amounts to capital expenditure accounts in funds other than enterprise and intragovernmental service funds.

Special Revenue Funds

In addition to the general fund and the debt service fund, governmental units may have many special revenue funds, generally provided for by statutory authority. Examples of such funds are fire protection, garbage, band, civil defense, street and bridge, levee fund, etc. Statutes authorizing such special tax levies generally require separate accountability over the tax collections and expenditures made therefrom. The independent auditor should test for proper allocation of the property tax collections to such special revenue funds and test expenditures for compliance with legal requirements.

Capital Project Funds

Large municipal projects, such as a new city hall, storm sewers, utility plant expansions, etc., are generally financed through the sale of general obligation or revenue bonds. To provide proper accountability over the proceeds of the sale of general obligation bonds, a capital projects fund is usually established for each project. Revenue bond proceeds are normally accounted for directly within the related enterprise fund.

Audit procedures for capital project expenditures will normally include tests for propriety. In addition, the auditor should consider reviewing construction contracts and change orders pertaining to uncompleted and unpaid contracts and other appropriate documents, such as federal grant agreements.

Reference should be made to local statutes in order to deter-

mine the authorized disposition or transfer of any bond issue proceeds remaining after completion of such projects.

Enterprise and Intragovernmental Service Funds

Examples of activities classified under enterprise funds include electric power and light, water and sewer, off-street parking, hospital, airport, golf course, and swimming pools.

Examples of intragovernmental service funds include central garages and motor pools, central printing services, and central purchasing and stores departments.

Generally, audits of these funds are comparable to audits of commercial enterprises. One exception is that in some of the funds it may be impracticable to confirm accounts receivable. In such situations, alternative audit procedures should be used. Another exception is that enterprise funds often sell revenue bonds to provide money for construction purposes.

Revenue Bonds. Revenue bonds are sold under the legal authorization of a revenue bond ordinance, which sets forth the terms and conditions of fiscal operation and the manner in which the bonds are to be redeemed. An understanding of the nature and use of revenue bonds and respective ordinances is necessary for an effective audit.

Unless supported by the revenue of the governmental unit, revenue bonds can only be redeemed from cash produced by revenue of the enterprise and are not underwritten or guaranteed by the general credit or taxing power of the municipality. Because of this limitation, the revenue bond ordinance purposely provides certain safeguards for the bond purchasers in the form of required special cash reserves and accounting policies.

The typical revenue bond ordinance sets forth (1) the purpose of the bond issue and restrictions on use of the bond proceeds, (2) the maturity redemption schedule, (3) the maximum interest rate (if applicable), (4) the special restricted cash accounts required, and provisions for transfer of cash to and from each account (usually identified as "funds" in a typical revenue bond ordinance), (5) the provisions for authorized transfers of excess funds for any lawful corporate purpose, and (6) the authorization for investment of cash accumulations in each of the restricted cash accounts.

The number of accounts ("funds") can range from very few to several, depending on the terms of the revenue bond ordinance. Typical accounts, presented in order of priority, are listed as follows (there are variations in account names depending upon the language of the ordinance):

- (a) Operation and maintenance account or gross revenue account.
- (b) Bond and interest account.
- (c) Bond reserve account.
- (d) Improvement, replacement, and extension account.
- (e) Surplus account.

The operation and maintenance account, as its name implies, represents the operating account into which all revenue flows and from which all operating expenditures are made. Generally, at the end of each month, all cash from revenue in excess of operating requirements for the succeeding month is to be transferred, to the extent available, to the special accounts, (b) through (e), as listed above.

Bond principal is generally paid annually and interest payments are made semiannually. Accordingly, the typical revenue bond ordinance requires a monthly cash transfer from the operation and maintenance account to the bond and interest account in the amount of $1/12$ of the next bond principal payment and $1/6$ of the next interest payment. Only bond principal and interest payments are to be made from the bond and interest account, and such account serves only as a medium for the payment of current maturities.

The bond reserve account, generally, represents a safeguard for the bondholders, receiving fixed monthly transfers from the operation and maintenance account until a maximum amount is in the reserve. Its primary purpose is to provide funds for bond principal and interest payments when deficiencies exist in the bond and interest account.

The improvement, replacement, and extension account receives monthly cash transfers from the operation and maintenance account in a fixed amount until a stated maximum is reached. The purpose of this account is to provide funds for

emergency or extraordinary repairs or extensions to the system. In some jurisdictions, cash from the account can be used to make up deficiencies in the bond and interest account. If cash is so required from this account, monthly payments into the account normally must be resumed until the maximum is again reserved.

The surplus account represents the residual account to which all remaining cash is transferred after the required transfers have been made to accounts (b) through (d). It serves as a protective account for the payment of bond principal and interest if deficiencies exist in the related restricted cash accounts; it also provides funds for purchase of bonds on the open market or for other lawful purposes. Many revenue bond ordinances, however, provide that a percentage of the cash accumulated in the surplus account may be transferred to the general fund to be used for any lawful corporate purpose.

Many revenue bond ordinances require comments by an independent auditor as to compliance or noncompliance with at least certain of the bond ordinance requirements. The independent auditor should be knowledgeable of the various provisions of the revenue bond ordinances, and his examination of the financial transactions of the enterprise fund or funds should be sufficient in scope to determine that the municipality has complied with legal requirements. The auditor should (1) satisfy himself that transfers of cash from the operation and maintenance account to the various reserve accounts are in conformity with the scheduled revenue bond ordinance requirements; (2) test the propriety of expenditures made from the various reserve accounts by reference to the provisions contained in the ordinance; and (3) evaluate whether the reserve balances are in conformity with requirements of the related bond indenture.

Trust and Agency Funds

Financial accountability by a municipality for trust and agency funds is that of an agent, acting in a fiduciary capacity for others, having no equity or ownership over such funds. Examples of funds under this category are deposit funds, escrow funds, payroll tax withholding fund, police pension fund, firemen's pension fund, state industrial accident fund, and state unemployment insurance (or trust) fund, etc.

In the review of deposit, escrow, and payroll tax withholding funds, the auditor should consider audit procedures to determine the extent of liability to others by examination of underlying documentation and confirmation where applicable and practicable.

The accountability for pension funds is similar to that of commercial pension funds. Accordingly, in the examination of financial statements of such funds the independent auditor would perform similar audit techniques and procedures. Moreover, he should be alert to legal and accounting requirements of funded and unfunded statutory reserves as well as any statutory investment restrictions.

Special Assessment Funds

Special assessments result from construction or improvement projects that benefit certain property owners rather than all citizens of the municipality. Such projects are generally represented by sidewalk improvements, curbs and gutters, street and road improvements, street lighting, storm and sanitary sewers, and others, in which benefited property owners are charged a proportionate share of the cost of the improvement. Typically, property owners may pay for their share of the costs in equal annual installments over a ten-year period. Special assessment bonds are usually sold to cover the approximate amount assessed to property owners. The principal and interest on such bonds normally are payable from collections from property owners.

Construction costs, engineering and legal fees, and other charges to the project may be tested, as appropriate, against supporting documentation.

Proceeds from the sale of bonds can be compared with the sale document and traced to the cash account of the related special assessment fund.

A copy of the court order or city ordinance which "spreads the roll" of costs to the various property owners should be made available for review by the auditor. The auditor should consider tracing on a test basis such charges to the subsidiary special assessment receivable records.

Normally, it is not practicable to confirm account balances of property owners. In such cases, the auditor should consider testing the unit's procedures and appropriate documentation to

compensate for the omission of confirmation procedures. A comparison of delinquency trends may be included in such testing.

Consideration should be given to testing principal and interest payments made by the property owners regarding proper applications to the subsidiary records, the general ledger control accounts, and the bank account.

In some jurisdictions segregation of principal and interest receipts is required to assure payment of special assessment bonds from "principal cash." Similarly, payment of special assessment bond interest would be made only from "interest cash."

Consideration should be given to examination of redeemed special assessment bonds and coupons for effective cancellation and for audit support of the remaining bonds outstanding.

SUMMARY AND CONCLUSION

The foregoing procedures are not necessarily all-inclusive, either as to specific audit procedures or as to individual funds to which they may be applied. The procedures appropriate in a particular instance depend in part on the applicable legal requirements, the system of internal accounting controls, and the records providing essential documentation of financial transactions.

Materiality will be a factor in determining appropriate audit procedures. Materiality should be measured in relation to the separate financial statements reported on for each fund (or group of related funds) or account group.

Finally, the independent auditor must maintain a continuing awareness of the environment of public scrutiny in which governmental units operate. The reader is referred again to the material on this subject in Chapter 4.

Financial Statements and Auditors' Reports

Chapter 6

Presentation of Financial Statements

General

Financial statements of governmental units are of interest to several diverse groups. However, they are especially important to elected officials and management as they provide the results of financial operations for the purpose of

. . . determining compliance with legal provisions and budgetary restrictions [and] as a means of determining the stewardship and efficiency of the various administrative departments and officers. . . .

Outside of the formal governmental organization itself, there are four principal groups of persons whose interests and decisions are dependent upon the financial information produced by the governmental accounting system. The general public, composed of individual citizens, taxpayers, and political groups, is vitally concerned with the cost of public services, the adequacy of revenues in meeting such costs, and the stewardship and efficiency of both elected and appointed public officials in administering the government's financial transactions. The second group is composed of investors, investment bankers, and bond rating services who are continuously interested in the financial status and operating results of such units, not only as a basis for appraising existing bonds and other outstanding debt instruments, but also for the purpose of analyzing the credit worthiness of the unit

insofar as future debt issues are concerned. With the development of extensive and complex intergovernmental fiscal relationships in the form of grants-in-aid, shared revenues, and administrative supervision, governments must be provided with adequate financial data on the operations of other governmental jurisdictions with which these relationships exist. . . . The fourth and final group is made up of educational and research organizations, statistical reporting agencies, and such individuals as accountants, financial analysts, economists, and political scientists whose professional activities embrace the study and improvement of public financial administration.¹

Because of this widespread interest in the affairs of government, larger governmental units generally are required by law to publish annual financial reports. Increasing numbers of these reports contain financial statements that have been examined by independent auditors, frequently in compliance with the requirements of local law.

Readers from the diverse groups described above will interpret financial statements in terms of the needs and purposes of the group they represent. The concern of the independent auditor reporting on the financial statements is that they present fairly financial position and results of operations in conformity with generally accepted accounting principles. The primary purpose of this chapter is to discuss the application of generally accepted accounting principles to the presentation of financial statements of governmental units.

Responsibility

The responsibility for the financial statements of both commercial enterprises and governmental units is that of the issuer.

Management [in this case, governmental officials] has the responsibility for adopting sound accounting policies, for maintaining an adequate and effective system of accounts, for the safeguarding of assets, and for devising a system of internal control that will, among other things, help assure the production of proper financial statements. The transactions which should be reflected in the accounts and in the financial statements are matters within the direct knowledge and control of management. . . . Accordingly, the fairness of the representations made through financial state-

¹ GAAFR, pp. 1 and 2.

ments is an implicit and integral part of management's responsibility. . . .²

The independent auditor has the responsibility of reporting whether management's financial statements are prepared in conformity with generally accepted accounting principles. In practice, however, the auditor frequently assists or advises responsible governmental officials on the preparation of the financial statements to assure conformity with generally accepted accounting principles.

Bases of Accounting

As discussed in Chapter 2, the modified accrual basis of accounting is appropriate for the general, special revenue, and debt service funds; for all other funds the accrual basis of accounting should, with certain exceptions, be followed.

Financial Statements Required

Generally, fair presentation of financial position and results of operations in conformity with generally accepted accounting principles requires that the financial statements of each fund include a balance sheet, a statement of revenues and expenditures (or separate statements of revenues and expenditures or, in each case, expenditures and encumbrances, whichever is appropriate), and a statement of changes in fund balance. In the case of an enterprise fund, in addition to the statements comparable to those mentioned above, a statement of changes in financial position is required, in accordance with Accounting Principles Board Opinion No. 19, "Reporting on Changes in Financial Position." Reference is made to Chapter 2 for a discussion as to presentation of the balance sheets of individual funds in a combined balance sheet and the circumstances under which it is appropriate to group homogeneous and nonhomogeneous funds in columns therein.

Trust and agency funds frequently have no fund balance and, in such instances, a statement of changes in fund balance would be inapplicable. Further, such funds may not have revenues and

² SAS No. 1, section 110, paragraph .02.

expenditures but rather receipts and disbursements; if they represent the operations of the funds they should be so presented.

With respect to the general fixed asset and long-term debt groups of accounts, a statement showing balances at the statement dates is necessary for presentation of financial position. However, changes in amounts during the accounting period are not considered to be "operations" and a schedule of such changes is not required. The latter would comprise supplementary information.

In addition to the required financial statements, a governmental unit may include operating statistics and commentary thereon or other information in its financial report.

The extent to which such information is included in a unit's financial report, if at all, is the option of the governmental unit. Such additional information is not necessary for a fair presentation in conformity with generally accepted accounting principles. If such information is included in the financial report, it should be clearly identified as supplemental information.

Disclosures

General. Lack of compliance with legal requirements dealing with financial matters should be disclosed in the financial statements, usually in a note. This disclosure is considered to be a matter of accounting principle.

Budget Information. As stated in Chapter 3, the statement of revenues and expenditures of the general and certain special revenue funds should include a comparison with a formal budget in order to be in conformity with generally accepted accounting principles. In addition, if the governmental unit being examined is required by law to adopt or to adopt and report on a budget for one or more of its operating funds, failure to do so would be an example of lack of legal compliance that would require disclosure in the financial statements.

Budget reporting requires that appropriate details be presented. The appropriate detail depends upon the level of budgetary control—line item or category. Where the budgetary control operates on a line item basis, a schedule supporting the statement of revenues and expenditures would usually be necessary since the statement would normally show only totals by category.

On the other hand, if the point of control in the budget is at the category level, the presentation of the budget by category on the face of the statement of revenues and expenditures would be sufficient and a supporting schedule showing expenditures and budget by line item would not be necessary for compliance purposes.

If violations of the budgetary control exist, this fact would be evident in the presentation of the data and no further comment or disclosure would be necessary. However, disclosure of material violations of other financial compliance matters would require a specific statement that the violation exists.

Some jurisdictions require that the final adjusted budget be presented in financial statements. Others require that financial statements show the original budget and adjustments as well as the final budget. The latter procedure, even if not required, may provide useful supplemental data for financial statement users.

Supplementary Information. Disclosures which cannot be set forth on the face of the financial statements are included in a note thereto. With respect to some disclosures, including certain budget disclosures as discussed above, the volume of information reported will be such that it can best be presented in a separate schedule, or in related commentary. In such situations, the separate schedule or related commentary material should be incorporated into the basic financial statements by reference either on the face of the statements or in a related footnote. To avoid misunderstanding by the reader, any statements or schedules presented as additional information that are not necessary for fair presentation in conformity with generally accepted accounting principles should not be referred to in the financial statements.

Relationship Between Funds. Since the various funds of a governmental unit are separate entities, generally the statements of any of the funds may be presented separately and be in conformity with generally accepted accounting principles. However, an interfund relationship may exist between funds that should be considered. For example, if a statement of revenues and expenditures were presented of a debt service fund showing interest and principal payments on bonds without a statement of general long-term debt, the details of such general long-term debt should be disclosed in the financial statements of the debt service

fund. This disclosure normally would include the nature and amount of the debt, interest rates, and payments required for at least the following year. However, if the statement of long-term debt was presented, together with the debt service fund statement, pertinent information need not be repeated in a footnote to the latter statement.

Another example of an interfund relationship frequently exists in the financial statements of a retirement fund. A fund contributing to a retirement fund is required to disclose pertinent details regarding the retirement plan. However, if the retirement fund statements are presented along with the statements of the contributing fund, duplicate disclosure may be omitted.

Special Problems in Financial Statement Presentation

There are a number of unusual problems frequently encountered in financial reports of governmental units. The more significant of these are discussed below.

Property Taxes Receivable Where Revenue Is Recorded on a Cash Basis. Where property tax revenue is recognized on a cash basis, a governmental unit may still have taxes billed but not collected. In such situations, the amount of the billed but uncollected taxes may be included on the balance sheet with an offsetting "contra" account entitled "Reserve for Uncollected Property Taxes." Where this is done, the accounting policies disclosure should specifically state that the amount shown as property taxes receivable has not been recorded as revenue.

Inventories. In enterprise and intragovernmental service funds, accounting principles applicable to inventories held for consumption by commercial enterprises should be followed. In other governmental funds, disbursements for such inventory items may be considered to be expenditures either at the time of purchase or at the time the items are used. Where inventories are considered to be expenditures at the time purchased, amounts on hand at the financial statement date may or may not be included on the balance sheet. If included on the balance sheet, the credit should be to an offsetting "contra" account "Reserve for Inventories." The accounting policies disclosure should then specifically state that the amount shown as inventory has been recorded as an expenditure.

Presentation of Interfund Account Balances. Unsettled interfund account balances resulting from transactions between funds during the year should be reported on the respective fund balance sheets or in a combined balance sheet if individual fund balance sheets are not presented. They should not be offset among funds. However, current amounts due from and due to the same funds should be offset and the net amounts shown on the respective fund balance sheets.

Reporting of General Obligation Bonds Financing Enterprise Improvements. Normally, general obligation bonds should be included in the long-term debt group of accounts; under all circumstances, debt of any type should not be recorded in more than one fund or group of accounts.

General obligation bonds being repaid by enterprise funds should be carried as liabilities of the enterprise fund to reflect the intention of retirement out of resources of that fund, where so indicated by the bond ordinance. The existence of the bonds should be included in a note to the statement of general long-term debt to reflect the contingent liability for payment of these bonds. (Similar treatment should be afforded special assessment bonds backed by the full faith and credit of the governmental unit.)

If the bond ordinance does not provide for regular and recurring annual payments of interest and principal payments on the general obligation bonds from earnings of the enterprise fund, the bond proceeds should be credited to "Municipality's Contributions" (or other appropriate title), instead of bonds payable on the books of the latter fund. The liability for the general obligation bonds should then be included in the statement of general long-term debt. Principal payments on the bonds from enterprise earnings would be charged to the above contribution account.

Reporting of Prior Year Encumbrances in Operating Statements. Where the encumbrance method of accounting is used, the offsetting debits are made to the budget appropriation accounts and are reflected in the statement of revenues, expenditures, and encumbrances or a separate statement of expenditures and encumbrances compared with authorizations.

Any balance remaining in the encumbrances outstanding account of the general fund at the close of each year should be liquidated during the succeeding year by charging directly to such account the expenditures relating to orders or other commitments which gave rise to the amount. Any remaining balance in the encumbrances outstanding account, debit or credit, after all transactions are completed, should be transferred to and reported in sundry expense, or a similar account, in the nondepartmental expenditure category of the statement of revenues, expenditures, and encumbrances of that fund, or in the separate statement of expenditures and encumbrances compared with authorizations, if so presented. A similar method should be followed with respect to the prior year encumbrances outstanding account in other funds.

Reporting Encumbrances Outstanding in the Balance Sheet. The total of encumbrances at year end should be shown on the balance sheet on a separate line between liabilities and fund balance.

Reserves. Reserves in a general or special revenue fund represent “contra” credits to related balance sheet assets, such as property taxes receivable (on a cash basis) or inventories of materials and supplies already charged to expenditures. As is evident from the nature of such items, they represent offsets to assets included in the balance sheet only on a memorandum basis, and accordingly the “contra” amounts should be segregated from the fund balance.

Establishing Revenue Bond Reserve Requirements Where a Deficit Exists in Retained Earnings Account of an Enterprise Fund. The typical revenue bond ordinance will provide that additions to “reserve” accounts should be provided from cash derived from net income arising from operations of the enterprise fund following issuance of revenue bonds. In a newly established utility or other enterprise fund, cash generated from net income is frequently available for fulfillment of reserve requirements, but there is no accumulation of retained earnings to cover the transfer to the reserve accounts. Even though a retained earnings (deficit) exists, the required reserve should be established in the correct amount and the deficit increased to the extent thereof.

Fund Balance. “Fund Balance” is a generic term, similar to “Stockholders’ Equity” in accounting for a commercial enterprise. It represents a category rather than a single account. Therefore, Fund Balance should be used as a caption, with information regarding the composition of the balance disclosed by showing the component parts, such as “Appropriated” or “Unappropriated.”

Recognition of Gains and Losses on Repurchase of a Governmental Unit’s Outstanding Bonds. Any gain resulting from the repurchase in the open market of revenue bonds outstanding in an enterprise fund should, in conformity with APB Opinion No. 26, be recognized currently in the period of extinguishment and identified as a separate item in the statement of revenue and expense of such fund. The criteria in APB Opinions Nos. 9 and 30 should be used to determine whether such gains are ordinary or extraordinary items. In the event that revenue bonds are repurchased in the open market at a loss the same accounting and reporting treatment would apply.

In the year in which revenue bonds are refunded in order to secure lower interest rates for the issuer the same accounting treatment described above would apply to any gains or losses realized therefrom.

Where a gain or loss is realized on the repurchase of outstanding general obligation bonds being repaid annually through a debt service fund, no recognition of such gain or loss in the accounts would be recorded because the liability for bonds repurchased would not be carried in the debt service fund. The actual cost of the bonds repurchased would be charged to the expenditure account “retirement of bonds” in that fund and reported accordingly.

Reporting on Legal Compliance With Respect to an Over-Expenditure of Total Appropriations in the General Fund. Most state budget laws prohibit units of local government from overspending total appropriations in their respective general funds. Where such over-expenditure occurs, legal requirements are generally satisfied by a timely amendment of the budget originally adopted or passage of a supplemental appropriation. In the rare instance where an over-expenditure occurs and corrective legal action has not been taken or is not available, the unit’s legal counsel should be consulted. In some jurisdictions the statutes

may provide for assumption by the responsible governmental official of personal liability for such over-expenditure. Depending upon legal requirements and advice of counsel as to whether there has been a violation of law, disclosure in the financial statements in addition to that stated on page 77 may or may not be necessary.

Reporting Advance Debt Service Payments Due One Day After Year End. In a debt service fund an advance payment is frequently made of interest and principal installments due one day after the year end, such as payments for installments due July 1 made on or before June 30 in a fiscal year ending on that date. If the budget for the fiscal year ending June 30 provides for such items, the expenditures should be recognized in such budget year. The amount of the principal payment would not be included in the statement of general long-term debt as of the close of the fiscal year.

Balance Sheet Format of Public Utilities Owned by Governmental Units. Nongovernmental public utilities commonly use an inverted format in their balance sheets. GAAFR recommends the conventional format balance sheet be used. Either format is acceptable.

Extent of Notes to Cover Provisions in Revenue Bond Indentures. The notes to the financial statements should contain a brief synopsis of the terms of a revenue bond ordinance or other indenture. As a minimum, this would generally consist of a description of the various "funds" (actually accounts) required to be established; the extent to which use of cash therein is restricted for the benefit of the bondholders; the sequence in which specified amounts of cash from net income are to be transferred into such funds; special reserve accounts to be established within given funds and the limitations on amounts required to be accumulated; and investment authorizations and related restrictions.

As described on page 72, the above synopsis may alternatively be presented in separate commentary and incorporated into the financial statements by reference on the face of the statements.

Disclosure Requirements With Respect to Violation of a Bond Indenture Provision. The facts and amounts concerning any ex-

isting default in principal, interest, sinking fund, or redemption provisions with respect to any issue of revenue or general obligation bonds, or any existing breach of covenant of a related indenture or agreement should be disclosed in the financial statements. In the case of revenue bonds reported directly as a liability of an enterprise fund, the entire amount of obligations to which the default or breach relates should be classified as a current liability if the existing default or breach accelerates the maturity of the obligation and makes it current under the terms of the related indenture or agreement. If a default or breach exists, but acceleration of the obligation has been waived for a stated period of time beyond the date of the most recent balance sheet, the amount of the obligation and the period of the waiver should be disclosed in the financial statements.

Reporting Problems Unique to Financing Authorities. In many states, statutes have been adopted authorizing the formation of financing authorities to finance construction of major improvements where governmental units are prohibited from issuing bonds directly for that purpose.

Generally, the practice followed is to form a financing authority, which then sells revenue bonds to finance construction of a school building or other structure and leases it to the sponsoring governmental unit. The period of the lease may or may not coincide with the term of the outstanding bonds.

Under the provisions of APB Opinions Nos. 5 and 7, a financing authority of the type described above qualifies for use of the financing method if a noncancellable lease exists. In such event, the lease should be carried as a receivable in the statements of the financing authority (lessor), with the revenue bonds outstanding carried as a liability, in accordance with the provisions of APB Opinion No. 7.

Under the financing method concept, the governmental unit (lessee) would report leased assets in its general fixed asset group of accounts and lease rentals payable due in future years in its general long-term debt group of accounts.

If the lease is cancellable, the operating method described in APB Opinion No. 7 would apply. Where the operating method applies, the financing authority should carry the cost of the building on its books, with the revenue bonds outstanding carried as a liability.

Even though the buildings are capitalized at cost, it is not recommended that depreciation thereon be computed. No operations are being conducted and depreciation is not a factor in determination of the rent to be charged.

Where the operating method of accounting applies to the financing authority, the buildings or other structures being leased may still revert to the governmental unit (lessee) at some future time. At the point of reversion, the assets should be included in the general fixed assets group of accounts at book value on the records of the financing authority.

Reporting of Depreciation in a Transportation System on Assets Acquired From Contributions in Aid to Construction. Certain public transportation systems, because of inadequate rate structures, are compelled to seek outside contributions to finance their facilities, including rolling stock, street cars, or buses. In most instances, local rates or fares won't generate sufficient revenues to cover more than the depreciation on assets acquired with the system's own funds. Future expansion would also be expected to be financed by further contributions in aid to construction from state or federal sources.

Net income from such systems should reflect depreciation on assets acquired from contributions in aid to construction. While depreciation on all assets should be shown in the income statement, the amount applicable to assets acquired from contributions in aid to construction should be transferred to the related contribution account instead of to retained earnings for the reasons set forth in the preceding paragraph. Such treatment is illustrated as follows:

Operating revenues		\$x,xxx,xxx
Operating expenses		xxx,xxx
Operating income before depreciation		xxx,xxx
Less Depreciation:		
On assets acquired with own funds	\$xxx,xxx	
On assets acquired from contributions in aid to construction	xxx,xxx	xxx,xxx
Net income (loss) for year		xx,xxx

Disposition of net income (loss) for year:	
Net income (loss)	\$ xx,xxx
Add credit arising from transfer of depreciation to contributions in aid to construction account	xxx,xxx
Income (loss) transferred to retained earnings	<u>xx,xxx</u>

Professional Pronouncements

Accounting Research Bulletin No. 43 states that “. . . the committee [Accounting Principles Board] has not directed its attention to accounting problems or procedures of religious, charitable, scientific, educational, and similar nonprofit institutions, municipalities, professional firms, and the like. Accordingly, except where there is a specific statement of a different intent by the committee [Accounting Principles Board], its opinions and recommendations are directed primarily to business enterprises organized for profit.”³

The Committee on Accounting Procedure (predecessor to Accounting Principles Board) used the term “primarily” and not the term “exclusively.” Thus the auditor needs to consider the applicability of existing pronouncements and be alert to new pronouncements as they are issued. As an aid to the auditor an analysis of professional pronouncements existing at the time of writing this audit guide has been made and comments as to the applicability thereof have been included in Appendix B.

³ ARB No. 43, Introduction, paragraph 5, published in June 1953, and reaffirmed by the APB in September 1961.

Chapter 7

The Independent Auditor's Report

Introduction

As discussed in Chapter 6, officials of the governmental unit have the responsibility for the financial statements. The independent auditor is responsible for his report on examination. The four reporting standards outlined in Statement on Auditing Standards No. 1, sections 400 and 500, are applicable to the auditor's report.

As in any audit engagement, the auditor's report may be presented with financial statements that he reproduces, with financial statements that the governmental unit reproduces, or both. If the auditor's report is presented with financial statements reproduced by the governmental unit, the auditor should approve the printer's proofs of the statements as a condition for inclusion of his report. If the auditor's report is presented both with financial statements he reproduces and with statements the unit reproduces, the auditor should require that the two sets of financial statements be identical. This requirement applies also to financial statements of a governmental unit published in a newspaper or other medium. While the financial statements should be identical, the extent of any supplementary information may vary.

Statements Examined

The auditor's engagement may include all of the funds and account groups of a governmental unit or only some of them. Further, financial statements for all of the funds and account groups may or may not be included in a single financial report. Both of these possibilities are factors to be considered by the auditor when he reports the scope of his audit.

Normally, the auditor will combine his reports on the financial statements of the various funds and account groups of a governmental unit in a single report letter. If he has examined all funds and account groups of a governmental unit, and financial statements for all funds and account groups are included in a single financial report, the auditor's report may appropriately refer to "the various funds and account groups" in both his statement of scope and his opinion.

If the auditor includes his report letter in a financial report that does not include financial statements for all funds and account groups of a governmental unit, he should specifically identify those financial statements included in the financial report that he did examine, both in describing the scope of his examination and in expressing his opinion. This may be done by a listing in his report or by other appropriate reference, such as reference to items in a table of contents or to page numbers. In the latter instances, the auditor should address his opinion to the respective financial statements to which reference has been made.

Further, when a financial report does *not* include financial statements of all funds and account groups, the auditor should consider whether a user of the financial report could be led to believe that it represented a complete report of all activities of the governmental unit. If the potential exists for a misleading inference as to completeness, the auditor should identify in his scope paragraph or in a separate paragraph, the financial statements that have been omitted from the financial report. In making this disclosure, the auditor should state whether the omitted financial statements have been audited, either by himself or by another auditor. If the governmental unit has failed to maintain accounting records for an omitted fund or account group, that fact should also be disclosed in the auditor's report.

In order to determine whether the financial statements of a fund have been omitted from the financial report, a conclusion

must be reached as to what constitutes a fund of the governmental unit. For example, factors in deciding whether a pension fund established for the employees of a governmental unit is a fund of the unit would involve the degree of autonomy of its governing body, the method of appointment of the members of the governing body, and the provisions of the pension trust and any applicable laws. In all cases, judgment is required in concluding which financial statements should be included in a governmental unit's financial report.

Whether a financial report includes financial statements for all or only some of the funds of a governmental unit, if any of the statements included are unaudited, the auditor should so state in his report. The unaudited statements should be so marked and a disclaimer thereon included in the auditor's report. If any of the included financial statements have been examined by other independent auditors, presumably the report of the other auditors will also be included. If so, no reference to the statements they have audited is necessary. However, if the report of the other auditors is not included, the auditor should disclose the facts. This would normally be done by adding a sentence to the auditor's statement of his scope, worded somewhat as follows: "We have not examined the financial statements of the Water and Sewer Fund, which have been examined and reported upon by other independent auditors." If there is any qualification in the report of the other auditor, this fact should be disclosed.

If a governmental unit presents financial statements that consolidate funds required to be reported separately, such consolidated statements would be additional information that normally would not require separate identification in the auditor's report. However, if such statements are presented in lieu of rather than in addition to required separate financial statements, the auditor should state that the statements are not in conformity with generally accepted accounting principles.

Auditor's Opinion

In his report, the independent auditor should express his opinion (or disclaim an opinion) as to whether the financial statements present fairly the financial position, results of operations and, where applicable, changes in financial position, of the various funds (or groups of related funds) and account groups

of the governmental unit in conformity with generally accepted accounting principles consistently applied.

As discussed in this audit guide, separate financial statements of the funds, groups of related funds, and account groups are necessary for fair presentation in conformity with generally accepted accounting principles. The auditor's opinion is an opinion on each of the respective financial statements. Because of this, the omission of a financial statement from a financial report, even if the omission requires disclosure in the auditor's scope paragraph, as noted above, should not result in any qualification in the opinion on the remaining statements. Further, circumstances leading to a qualification, disclaimer, or adverse opinion on one financial statement would not necessarily affect the auditor's opinion on other financial statements.

In the circumstances described below, the auditor may simplify his expression of opinion. If (a) a governmental unit has established all funds and account groups the auditor believes are necessary, (b) appropriate financial statements for all funds and account groups are presented, (c) a combined balance sheet¹ is presented, and (d) the auditor has examined all of the financial statements, the independent auditor may state simply that the financial statements present fairly the financial position and results of operations of the governmental unit; his opinion expressed in that form is intended to have the same significance as an opinion expressed with respect to the separate financial statements of each fund (or groups of related funds) and account group. If a statement of changes in financial position of an enterprise fund is included in the statements, an appropriate separate reference thereto is necessary.

The independent auditor should express his opinion as to conformity with generally accepted accounting principles. It is unnecessary to add the modification "applicable to governmental entities." Generally accepted accounting principles comprehend the use of those principles applicable in the circumstances. Further, applicable accounting policies are required to be disclosed in the financial statements,² thus eliminating any need to call

¹ See page 20 for a definition of a combined balance sheet as used in governmental accounting.

² See APB Opinion No. 22 and Appendix B of this guide.

attention to the fact that applicable accounting principles differ from other types of organizations.

Financial Statements Prepared on the Modified Accrual Basis. In Chapter 2 it was stated that the use of the modified accrual basis was appropriate in accounting for transactions in budgetary funds, namely, the general, special revenue, and debt service funds. Financial statements prepared on the modified accrual basis of accounting for the above funds are in conformity with generally accepted accounting principles and, if consistently applied, an unqualified opinion may be expressed thereon.

Reporting on Financial Compliance With Legal Requirements. The auditor may be asked to report on the compliance of specified financial transactions with legal requirements. Where a required report of the transactions can be shown in a supplemental schedule, this form should be used and any required comment by the auditor included in his report. In such circumstances, an unqualified opinion may be expressed on the financial statements.

Where opinions are expressed on the compliance of financial statements or supplemental schedules with legal requirements, e.g., the reporting of transactions on a cash basis under a revenue bond ordinance, the opinion should state whether or not they were prepared in conformity with applicable legal requirements. With respect to financial statements, the auditor's report should also state that the statements have not been prepared in conformity with generally accepted accounting principles, if such is the case. In such event, the independent auditor would be precluded from expressing an unqualified opinion and should refer to SAS No. 1 for guidance with respect to the appropriate wording to be used in such an opinion.

As stated in Chapter 6, lack of compliance with legal requirements dealing with financial matters should be disclosed in the financial statements, usually in a note. Generally, if lack of compliance is properly disclosed, no comment is necessary in the auditor's report. Reference is made to SAS No. 1, section 545.01 when lack of compliance is not properly disclosed. In some cases, determining whether the governmental unit has complied with a particular law may require an interpretation which is beyond the competence of the auditor or the effect on the financial state-

ments may not be determinable. (For example, an official may be required to repay an unauthorized expenditure, but the auditor may be unable to determine the collectibility of the amount.) In such an instance, the auditor should consider whether to qualify his opinion because of the uncertainty.

It is frequently necessary for the auditor, in connection with an examination of financial statements, to report on financial compliance with the requirements of bond ordinances or other laws or ordinances. Such a report may be issued as a separate letter (see example L on page 131), or it may be included in the auditor's report on financial statements.

Auditor's Responsibility for Budget Information

As set forth in Chapters 3 and 6, the statement of revenues and expenditures of the general fund and certain special revenue funds should include a comparison with a formal budget in order to be in conformity with generally accepted accounting principles.

The auditor's responsibility with respect to such budget information is restricted to ascertaining that the budget (including the original and any amended budget) has been formally adopted, or otherwise approved, and has been presented in the manner described in Chapter 3, page 29.

Reporting on Supplemental Information

A financial report of a governmental unit may include a wide variety of supplemental information in addition to the financial statements (including notes) of its funds and account groups. The auditor should indicate the extent of his examination of such data and his opinion, if any, on it.³

Specific Reporting Considerations

Following is a discussion of several reporting considerations the independent auditor may encounter.

Inadequate Disclosure. As stated in Chapters 3 and 6, if the governmental unit being examined is required by law to adopt and report on a budget for one or more of its operating funds,

³ SAS No. 1, section 610.02.

failure to adopt and report on such budgets would be an example of lack of legal compliance that would require disclosure in the financial statements. If such disclosure is not made, the independent auditor should appropriately qualify his opinion, giving as his reason the omission of the disclosure of the failure to comply with the legal requirement. Reference is made to SAS No. 1, section 545.01 for further guidance.

Cash Basis Statements. Some governmental units prepare their financial statements on a cash basis. In such situations the provisions of SAS No. 1, section 620, paragraphs .05-.06, should be followed. See also "Sample Auditors' Reports," Example H, page 127 for an opinion on statements prepared on the cash basis.

Revenue Auditing Problems. In some cases, such as with certain parking authorities, it is not possible for the auditor to satisfy himself that all revenues have been recorded. Under these circumstances, the auditor should report that his examination of revenues was limited to amounts recorded. He should then appropriately qualify his opinion.

Exceptions Relating to an Encumbrance System. If the use of an encumbrance system is not required by local law, the independent auditor may disregard it and take no exception in his opinion. In rare situations where a prescribed encumbrance system may not have been followed, the independent auditor should consider the materiality thereof, taking into account the differences between the methods required and followed at both the beginning and end of the year. If the amount thereof is material, both the failure to use the encumbrance system and the effect thereof should be disclosed in the financial statements. If such disclosure is not made, the auditor should take an exception thereto in his report.

Illustrative Auditors' Reports. See "Sample Auditors' Reports," pages 119-131, which illustrate many of the report letters discussed in this chapter.

**Illustrative Forms of Certain Financial
Statements and Supplemental
Schedules of Governmental Units**

INTRODUCTION

The purpose of these examples is to illustrate financial statements and supplemental schedules for which examples are not found in GAAFR or which represent preferable alternatives to Statement and schedules shown therein. They do not represent a complete or typical set of financial statements.

Example

1. Summary of types of financial statements and supplemental schedules often found in a typical audit report of a municipality, school district, or other governmental unit maintaining multiple funds, illustrated in the form of a table of contents.

Financial statements:

2. Comparative balance sheets of a general fund of a city.
3. Statement of revenues, expenditures, and encumbrances—general fund (integrated statement—alternative format).
4. Statement of revenues, expenditures, and encumbrances—general fund (integrated statement).
5. Statement of revenues, expenditures, encumbrances, and transfers—general fund (integrated statement).
6. Statement of changes in fund balances/retained earnings—all funds (combined format).
7. Statement of changes in financial position (enterprise funds only).
8. Notes to Financial Statements—Summary of Significant Accounting Policies.

Supplemental schedules:

9. Net cash earnings and allocation thereof under revenue bond ordinance.
10. Analysis of operating and restricted funds under revenue bond ordinance.
11. Cash and investments in operating and restricted funds.

NAME OF GOVERNMENTAL UNIT

Table of Contents

Auditors' Report

Financial Statements (comparative with prior year where meaningful):

Balance Sheets:

Combined Balance Sheet—all funds and account groups, and/or balance sheets of individual funds and account groups

Statement of Revenue—Estimated and Actual—for each budgeted fund, and

Statement of Expenditures and Encumbrances Compared with Authorizations—for each budgeted fund, or

Statement of Revenues, Expenditures, and Encumbrances—for each budgeted fund

Statement of Revenue and Expense (or Statement of Income)—for enterprise and intragovernmental service funds

Statement of Changes in Fund Balances/Retained Earnings—for each fund or combined for all funds

Statement of Changes in Financial Position (enterprise funds only)

Supplemental Schedules:

Supplemental Analyses and Commentary (as appropriate)

Various Schedules (illustrative only):

Analysis of Revenues (detail by funds as appropriate)

Analysis of Expenditures (detail by funds as appropriate)

Investments

Bonds Payable

Analysis of Changes in General Fixed Assets

Assessed Valuation, Tax Levies, and Tax Collection Experience

Insurance Coverage

Explanation

1. The above represents a table of contents for a typical audit report of a municipality, school district, or other governmental unit maintaining multiple funds. However, it is illustrative only.
2. For budgeted funds it is considered preferable to combine the Statements of Revenue—Estimated and Actual, and Expenditures and Encumbrances Compared with Authorizations into a single integrated statement, as set forth in the optional listing above. See Examples 3, 4, and 5 for acceptable presentations.
3. The use of supplemental analyses and commentary is optional, as appropriate; they may be positioned either before or after the supplemental schedules.

NAME OF GOVERNMENTAL UNIT

General Fund
Balance Sheet, December 31, 19X2 and 19X1

<u>Assets</u>	<u>19X2</u>	<u>19X1</u>
Cash	\$ 14,518	\$ 8,213
Time Certificates of Deposit	145,000	
United States Treasury Bills—At cost (par value, \$175,000; market value, \$173,563)		171,461
Property Taxes Receivable (Less allowance for uncollectible amounts, 19X2—\$11,000; 19X1—\$9,500)	18,472	16,501
Accounts Receivable	2,145	
Due From Other Funds	8,500	
Note Receivable—Due August 5, 19X3, 6% interest	2,775	
Deposits	664	664
Inventory of Supplies	15,000	5,000
Total	<u>\$207,074</u>	<u>\$201,839</u>
<u>Liabilities, Reserves, and Fund Balance</u>	<u>19X2</u>	<u>19X1</u>
Liabilities:		
Vouchers payable	\$ 28,612	\$ 91,504
Payroll taxes payable	2,580	2,079
Total liabilities	<u>31,192</u>	<u>93,583</u>
Encumbrances Outstanding	<u>38,000</u>	<u>5,374</u>
Reserve for Inventory of Supplies	<u>15,000</u>	<u>5,000</u>
Fund Balance:		
Appropriated	100,000	
Unappropriated	<u>22,882</u>	<u>97,882</u>
Total fund balance	<u>122,882</u>	<u>97,882</u>
Total	<u>\$207,074</u>	<u>\$201,839</u>

Explanation

The purpose of this example is to illustrate the appropriate presentation of:

1. A comparative balance sheet.
2. The inclusion on the balance sheet of a receivable for uncollected property taxes recorded on the accrual basis.
3. The separation of the reserves from the fund balance section of the balance sheet. The reserve for inventory illustrated is based on the expensing of inventory purchases during the year and recording inventory amounts at year end on a memorandum basis.
4. The composition of the fund balance at the balance sheet date; the amount of \$100,000 shown as appropriated at December 31, 19X2 represents the amount so appropriated in the budget for the year ended December 31, 19X3.

NAME OF GOVERNMENTAL UNIT

General Fund

Statement of Revenues, Expenditures, and Encumbrances
for years ended December 31, 19X2 and 19X1
(Integrated Statement—Alternative Format)

	Budget Expenditures		Encum- brances	Actual	Over (Under) Budget	Actual Prior Year
	Budget	Expenditures				
Revenues:						
Taxes	\$ 832,500			\$ 831,300	\$ (1,200)	\$ 775,400
Licenses and permits	125,500			103,000	(22,500)	84,500
Intergovernmental revenue	200,000			186,500	(13,500)	146,700
Charges for services	90,000			91,000	1,000	86,500
Fines and forfeitures	32,500			33,200	700	29,100
Miscellaneous	19,500			19,500		18,600
Total revenues	1,300,000			1,264,500	(35,500)	1,140,800

Expenditures and Encumbrances:

General government	129,000	\$ 120,305	\$ 4,200	124,505	(4,495)	104,330
Public safety	277,300	252,795	6,550	259,345	(17,955)	234,780
Highways and streets	94,500	86,000	5,500	91,500	(3,000)	86,500
Sanitation	50,000	46,900	3,000	49,900	(100)	45,720
Health	47,750	40,850	4,600	45,450	(2,300)	40,490
Welfare	51,000	46,000	2,100	48,100	(2,900)	43,200
Culture-recreation	59,000	53,400	3,850	57,250	(1,750)	48,170
Education	591,450	555,250	8,200	563,450	(28,000)	542,790
Total expenditures and encumbrances	1,300,000	\$1,201,500	\$38,000	1,239,500	(60,500)	1,145,980
Excess (Deficiency) of Revenues Over Expenditures and Encumbrances	\$ —		\$ 25,000	\$ 25,000	\$ 25,000	\$ (5,180)

(See page 105 for a description of the purpose of this example.)

NAME OF GOVERNMENTAL UNIT

General Fund
Statement of Revenues, Expenditures, and Encumbrances
for years ended December 31, 19X2 and 19X1
(Integrated Statement)

	<u>Budget</u>	<u>Actual</u>	<u>Over (Under) Budget</u>	<u>Actual Prior Year</u>
Revenues:				
Taxes	\$ 832,500	\$ 831,300	\$ (1,200)	\$ 775,400
Licenses and permits	125,500	103,000	(22,500)	84,500
Intergovernmental revenue	200,000	186,500	(13,500)	146,700
Charges for services	90,000	91,000	1,000	86,500
Fines and forfeitures	32,500	33,200	700	29,100
Miscellaneous	19,500	19,500		18,600
Total revenues	<u>1,300,000</u>	<u>1,264,500</u>	<u>(35,500)</u>	<u>1,140,800</u>
Expenditures and En- cumbrances:				
General government	129,000	124,505	(4,495)	104,330
Public safety	277,300	259,345	(17,955)	234,780
Highways and streets	94,500	91,500	(3,000)	86,500
Sanitation	50,000	49,900	(100)	45,720
Health	47,750	45,450	(2,300)	40,490
Welfare	51,000	48,100	(2,900)	43,200
Culture-recreation	59,000	57,250	(1,750)	48,170
Education	591,450	563,450	(28,000)	542,790
Total expenditures and encumbrances	<u>1,300,000</u>	<u>1,239,500</u>	<u>(60,500)</u>	<u>1,145,980</u>
Excess (Deficiency) of Revenues Over Ex- penditures and En- cumbrances	<u>\$ —</u>	<u>\$ 25,000</u>	<u>\$ 25,000</u>	<u>\$ (5,180)</u>

(See page 105 for a description of the purpose of this example.)

NAME OF GOVERNMENTAL UNIT

General Fund
Statement of Revenues, Expenditures, Encumbrances, and Transfers
for years ended December 31, 19X2 and 19X1
(Integrated Statement)

	<u>Budget</u>	<u>Actual</u>	<u>Over (Under) Budget</u>	<u>Actual Prior Year</u>
Revenues:				
Taxes	\$ 772,500	\$ 771,300	\$ (1,200)	\$ 775,400
Licenses and permits	125,500	103,000	(22,500)	84,500
Intergovernmental revenue	200,000	186,500	(13,500)	146,700
Charges for services	90,000	91,000	1,000	86,500
Fines and forfeitures	32,500	33,200	700	29,100
Miscellaneous	19,500	19,500	—	18,600
Sale of real property	—	75,000	75,000	—
	<hr/>	<hr/>	<hr/>	<hr/>
Total revenues	1,240,000	1,279,500	39,500	1,140,800
Transfers From Other Funds				
	<hr/>	<hr/>	<hr/>	<hr/>
Total revenues and transfers	1,340,000	1,379,500	39,500	1,140,800
	<hr/>	<hr/>	<hr/>	<hr/>
Expenditures and En- cumbances:				
General government	129,000	199,505	70,505	104,330
Public safety	277,300	259,345	(17,955)	234,780
Highways and streets	94,500	91,500	(3,000)	86,500
Sanitation	50,000	49,900	(100)	45,720
Health	47,750	45,450	(2,300)	40,490
Welfare	51,000	48,100	(2,900)	43,200
Culture-recreation	59,000	57,250	(1,750)	48,170
Education	591,450	563,450	(28,000)	542,790
	<hr/>	<hr/>	<hr/>	<hr/>
Total expenditures and encum- brances	1,300,000	1,314,500	14,500	1,145,980

(Continued on next page.)

EXAMPLE 5, cont'd

	<u>Budget</u>	<u>Actual</u>	<u>Over (Under) Budget</u>	<u>Actual Prior Year</u>
Transfers to Other Funds	<u>40,000</u>	<u>40,000</u>	<u>—</u>	<u>—</u>
Total expenditures, encumbrances, and transfers	<u>1,340,000</u>	<u>1,354,500</u>	<u>14,500</u>	<u>1,145,980</u>
Excess (Deficiency) of Revenues and Trans- fers Over Expendi- tures, Encumbrances, and Transfers	<u>\$ —</u>	<u>\$ 25,000</u>	<u>\$ 25,000</u>	<u>\$ (5,180)</u>

(See page 105 for a description of the purpose of this example.)

Explanation of Examples 3, 4, and 5

- (A) Examples 3, 4, and 5 illustrate combining of the statement of revenues—actual and budgeted and the statement of expenditures and encumbrances compared with authorizations into a single integrated statement.
Examples 4 and 5 illustrate the merging of encumbrances with expenditures for the year, which is a simpler presentation than the alternative format reflected in Example 3.
- (B) The examples omit the detailed break-down of categories of revenue and of expenditures and encumbrances. In practice these may be shown in supporting schedules.
- (C) “Over (Under) Budget” and “Actual Prior Year” columns are optional.
- (D) In these examples of integrated statements, where estimated revenue and appropriation amounts have been revised during the year, the final amounts should be used and the column captioned “Final Budget.”
- (E) Example 5 illustrates the inclusion of transfers both from and to other funds in the integrated statement of revenues, expenditures, and encumbrances. Included is the reporting of the receipt of non-budgeted revenue in amount of \$75,000 from sale of real property. This example also shows the reporting of an over-expenditure of the budget for the general government category by \$70,505.

EXAMPLE 6

NAME OF GOVERNMENTAL UNIT

Statement of Changes in Fund Balances/Retained Earnings—
All Funds, for the year ended December 31, 19X2
(Combined Format)

	General Fund	Debt Service Fund	Capital Improvements (Projects) Fund	Enterprise Fund	Intra- Governmental Service Fund	Special Assess- ment Funds
Balances January 1, 19X2	\$ 97,882	\$374,966	\$74,648	\$343,479	\$10,576	\$37,344
Add:						
Excess of revenues (and transfers) over expenditures (and encum- brances) for the year	25,000	24,833		23,053	722	1,710
Net income for the year						
Transferred from reserve for bond retirement				1,200		
Total	<u>122,882</u>	<u>399,799</u>	<u>74,648</u>	<u>367,732</u>	<u>11,298</u>	<u>39,054</u>

Deduct:

Excess of expenditures (and encumbrances) over revenues for the year

6,865

Balances December 31, 19X2

\$122,882

\$399,799

\$67,783

\$367,732

\$11,298

\$39,054

Explanation

This example illustrates a combined format for a statement of changes in fund balances for all funds. This is an alternative to presentation of such statements by individual funds in a separate statement or combined with the individual fund statement of revenues and expenditures. Either mode of presentation is acceptable.

The example also illustrates a capital improvements fund found in many governmental units, in which annual revenues from continuing sources are available, such as from sales tax. The annual excess (or deficiency) of revenues over expenditures and encumbrances would be shown in the related statement and in this statement as illustrated herein.

NAME OF GOVERNMENTAL UNIT

Water and Sewer Fund
Statement of Changes in Financial Position
for the years ended December 31, 19X2 and 19X1

	<u>19X2</u>	<u>19X1</u>
Source of Funds		
Operations:		
Net income for the year	\$ 58,019	\$ 55,113
Items not requiring current outlay of funds:		
Depreciation	109,920	108,385
Loss on abandoned reservoir		9,334
Total operations	<u>167,939</u>	<u>172,832</u>
Contributions in Aid to Construction	60,169	65,610
Water and Sewer Connection Fees	51,127	26,156
Total	<u><u>\$279,235</u></u>	<u><u>\$264,598</u></u>
Application of Funds		
Additions to Utility Plant in Service	\$199,331	\$146,038
Payment of Long-Term Debt	44,821	48,752
Investment in Stock of Water Company	57	10,404
Increase in Restricted Funds	23,473	4,138
Increase in Working Capital	11,553	55,266
Total	<u><u>\$279,235</u></u>	<u><u>\$264,598</u></u>
	<u>Increase</u>	<u>Increase</u>
	<u>(Decrease)</u>	<u>(Decrease)</u>
Various Elements of Net Increase in Working Capital:		
Cash	\$(25,521)	\$ 14,492
Time certificates of deposit	45,000	45,000
Accounts receivable	4,480	(3,422)
Due from other funds		(600)
Prepaid expense	210	166
Bonds payable—current portion	(1,000)	(2,000)
Contracts payable—current portion	(2,931)	(2,110)
Accounts payable	(8,685)	3,640
Due to other funds		100
Total	<u><u>\$ 11,553</u></u>	<u><u>\$ 55,266</u></u>

NAME OF GOVERNMENTAL UNIT

Notes to Financial Statements

December 31, 19X2

Note to reader: The following example is illustrative of a typical summary of accounting policies peculiar to a governmental unit having both budgetary and enterprise funds. However, a governmental unit may follow other accounting policies having a significant impact on the financial statements which represent a selection of existing acceptable alternatives or unusual applications of generally accepted accounting principles that would require inclusion in the summary.

I. Summary of Significant Accounting Policies

The accounting policies of (Name of Governmental Unit) conform to generally accepted accounting principles as applicable to governmental units. The following is a summary of the significant policies.

Bases of Accounting. The accrual basis of accounting is followed (with minor exceptions) by all funds other than budgetary funds (general, special revenue, and debt service funds), which utilize the modified accrual basis of accounting. Modifications in such method from the accrual basis follow:

Note to reader: See Bases of Accounting, pages 13-17 for a discussion and summary of typical modifications to the accrual basis; applicable items should be considered for inclusion in this note.

Investments. Investments are stated at cost.

Inventories. Inventory held by the (Name of Enterprise Fund) is priced at cost. Inventory shown in the general fund consists of expendable supplies held for consumption. The amount thereof has been recorded for information purposes only as an asset, offset by a reserve in an equal amount. The cost value of such inventory has been recorded as an expenditure at the time individual inventory items were purchased.

Utility Plant in Service. Utility plant in service is stated at cost. Depreciation has been provided using the (straight-line, declining-balance, etc.) method.

General Fixed Assets. General fixed assets purchased are recorded as expenditures in the (general fund, capital projects fund, etc.) at time of purchase. Such assets are capitalized at cost in the general fixed assets group of accounts except for certain improvements other than buildings, including roads, bridges, curbs and gutters, streets and sidewalks, drainage systems, and lighting systems. Gifts or contributions are recorded in general fixed assets at fair market value at the time received.

No depreciation has been provided on general fixed assets. (Or, depreciation has been provided using the (straight-line, declining-balance, etc.) method.)

NAME OF GOVERNMENTAL UNIT

Water and Sewer Fund
 Net Cash Earnings and Allocation Thereof
 Under Revenue Bond Ordinance
 for the year ended December 31, 19X2

Net Income—(Exhibit)	\$ 72,951
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Add:

Interest on bonds	\$56,462	
Paying agent's fees	156	
Contributions from connection fees	13,304	
Depreciation	6,218	
Increase in accounts payable	1,381	77,521
Total		150,472

Deduct:

Increase in accounts receivable	563	
Interest income	22,645	
Extraordinary income	8,198	31,406

Net Cash Earnings Before Bond Interest and Contributions Available for Allo- cation Under Bond Ordinance	119,066
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Deduct Transfers To:

Revenue Bond Redemption and Interest Fund	71,618	
Replacement and Extension Fund	47,448	119,066

Balance Retained in Operating Fund	None
------------------------------------	------

Explanation

This example illustrates the conversion of net income, as reflected in an income statement prepared from accounting records maintained on the accrual basis, to net cash earnings before bond interest and contributions available for allocation (cash from net income and certain nonincome items) and disposition thereof under the terms of the related revenue bond ordinance. See Example 10 for distribution to the recipient "restricted cash accounts," usually described as "funds" in the typical revenue bond ordinance.

NAME OF GOVERNMENTAL UNIT

Water and Sewer Fund
Analysis of Operating and Restricted Funds Under Revenue Bond Ordinance
for the year ended December 31, 19X2

	Operating Fund	Revenue Bond Redemp- tion and Interest Fund	Reserve Fund	Replace- ment and Extension Fund	Total
Balance, December 31, 19X1— Cash and investments	\$63,699		\$100,000	\$157,454	\$321,153
Receipts:					
Transfer from net income (Example 9)		\$71,618		47,448	119,066
Interest income	8,366		4,091	10,188	22,645
Transfer from Reserve Fund	3,992				3,992
Total	76,057	71,618	104,091	215,090	466,856

Disbursements:			
Bond interest	56,462		56,462
Redemption of revenue bonds	15,000		15,000
Paying agents' fees	156		156
Trustees' fees		99	99
Transfer to Operating Fund		3,992	3,992
Extensions to sewer system			
Additions to plant and equipment		31,806	31,806
Total	<u>71,618</u>	<u>4,091</u>	<u>1,059</u>
			<u>108,574</u>
Balance, December 31, 19X2—			
Cash and investments	<u>\$ —</u>	<u>\$100,000</u>	<u>\$358,282</u>
	<u>\$76,057</u>	<u>\$182,225</u>	<u>\$358,282</u>

NAME OF GOVERNMENTAL UNIT

Water and Sewer Fund
Cash and Investments in Operating and Restricted Funds
December 31, 19X2

	Total	Cash	Cost	Investments Maturity Value	Market Value
Operating Fund:					
United States Treasury					
bills—due:					
7/16/X3			\$ 37,475	\$ 39,000	\$ 38,918
8/27/X3			28,962	30,000	29,739
Total	\$ 76,057	\$ 9,620	66,437	69,000	68,657
Reserve Fund:					
United States Treasury					
bonds—due:					
2/15/X3, 4%			50,000	50,000	47,090
8/15/X3, 4%			9,916	10,000	8,919
11/15/X3, 4½%			27,460	29,000	25,833
2/15/X4, 4½%			11,955	12,000	10,586
Total	100,000	669	99,331	101,000	92,428

Replacement and Extension					
Fund:					
United States Treasury					
bills—due:					
7/ 2/X3	24,951	26,000	25,996		
7/30/X3	24,037	25,000	24,895		
9/17/X3	65,701	68,000	67,076		
11/12/X3	38,564	40,000	39,036		
12/17/X3	19,308	20,000	19,398		
Total	<u>182,225</u>	<u>179,000</u>	<u>176,401</u>		
	<u>\$358,282</u>	<u>\$349,000</u>	<u>\$337,486</u>		
Total					

Note: Presentation of detailed maturity dates of United States Treasury bills is considered optional.

Sample Auditors' Reports

INTRODUCTION

The purpose of these sample auditors' reports is to illustrate selected situations. They are not intended to be all-inclusive. The auditor is referred to Chapters 6 and 7 of this guide for narrative discussions on subjects illustrated in the sample reports in this section. He should also consult Statement on Auditing Standards No. 1, especially section 500, the "Fourth Standard of Reporting," and section 600, "Other Types of Reports," for further guidance.

Example

- A. All funds examined, unqualified opinion on financial statements and on supplemental schedules and related information.
- B. All funds presented not examined, supplemental information reported on in part.
- C. Combined balance sheet with total column presented and opinion expressed on financial statements of the governmental unit.
- D. Qualification for failure to disclose information regarding a budget.
- E. Auditors' report calls attention to omission of financial statements.
- F. General fixed asset group of accounts not maintained.
- G. Scope of examination limited to recorded revenues.
- H. Special report—opinion on statements prepared on cash basis.
- I. Adverse opinion because of inadequacies in accounting for utility plant in service in an enterprise fund.
- J. Disclaimer of opinion with respect to special assessment funds, resulting from lack of availability of records.
- K. Report on financial statements prepared in accordance with legal requirements.
- L. Bond compliance letter.

ALL FUNDS EXAMINED, UNQUALIFIED OPINION ON
FINANCIAL STATEMENTS AND ON SUPPLEMENTAL
SCHEDULES AND RELATED INFORMATION

Independent Auditors' Report

Honorable City Council,
City of X:

We have examined the financial statements of the various funds and account groups of the City of X for the year ended December 31, 19X2, listed in the foregoing table of contents. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned financial statements present fairly the financial position of the various funds and account groups of the City of X at December 31, 19X2, and the results of operations of such funds and the changes in financial position of the Water Utility Fund for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

The accompanying supplemental schedules and related information presented on pages X to XX are not necessary for a fair presentation of the financial statements, but are presented as additional analytical data. This information has been subjected to the tests and other auditing procedures applied in the examination of the financial statements mentioned above and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole.

(s) *Firm Name*

February 12, 19X3

ONE FUND PRESENTED NOT EXAMINED,
SUPPLEMENTAL INFORMATION REPORTED ON IN PART

Independent Auditors' Report

Honorable City Council,
City of X:

We have examined the financial statements of the various funds and account groups of the City of X for the year ended December 31, 19X2, shown on pages X through XX. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We did not examine the financial statements of the Building Authority Fund shown on pages XX and XX and we express no opinion on them.

In our opinion, the aforementioned financial statements which we examined present fairly the financial position of such funds and account groups of the City of X at December 31, 19X2, and the results of operations of such funds for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

The accompanying supplemental information is not necessary for a fair presentation of the financial statements, but is presented as additional analytical data. This information, except for the statistical information presented on pages XX and XX, has been subjected to the tests and other auditing procedures applied in the examination of the financial statements mentioned above and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole.

(s) *Firm Name*

February 12, 19X3

COMBINED BALANCE SHEET WITH TOTAL COLUMN
PRESENTED AND OPINION EXPRESSED ON
FINANCIAL STATEMENTS OF THE GOVERNMENTAL UNIT

Independent Auditors' Report

Honorable City Council,
City of X:

We have examined the financial statements of the various funds and account groups of the City of X for the year ended December 31, 19X2, listed in the foregoing table of contents. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements listed in the aforementioned table of contents present fairly the financial position of the City of X at December 31, 19X2, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

The accompanying supplemental information and the column on the accompanying combined balance sheet captioned "Total—Memorandum Only" are not necessary for a fair presentation of the financial statements, but are presented as additional analytical data. The supplemental information has been subjected to the tests and other auditing procedures applied in the examination of the financial statements listed in the foregoing table of contents and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole.

(s) *Firm Name*

February 12, 19X3

Note: In this example, the table of contents referred to in the auditors' report lists the combined balance sheet (which in this case includes a column captioned "Total—Memorandum Only") and the separate statements of revenues and expenditures (expenses) of the various funds.

**QUALIFICATION FOR FAILURE TO DISCLOSE
INFORMATION REGARDING A BUDGET**

Independent Auditors' Report

Honorable City Council,
City of X:

We have examined the balance sheet of the General Fund of the City of X as of December 31, 19X2, and the related statements of revenues and expenditures and changes in fund balance for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The accompanying statement of revenues and expenditures of the General Fund for the year 19X2 does not include a comparison with a formal budget, as required by generally accepted accounting principles, nor does the statement disclose, also as required by generally accepted accounting principles, that the City Council has failed to adopt a budget for such Fund, as required by law.

In our opinion, except for the omission of the information mentioned in the preceding paragraph, the aforementioned financial statements present fairly the financial position of the General Fund of the City of X at December 31, 19X2, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

(s) Firm Name

February 12, 19X3

**AUDITORS' REPORT CALLS ATTENTION TO
OMISSION OF FINANCIAL STATEMENTS**

Independent Auditors' Report

Honorable City Council,
City of X:

We have examined the financial statements of the various funds and account groups of the City of X for the year ended December 31, 19X2, listed in the foregoing table of contents. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The financial statements of the City of X Water and Sewer Fund for the year ended December 31, 19X2, have not been included in the accompanying financial report. However, we have examined the financial statements of such fund and have issued our separate report thereon dated February 3, 19X3.

In our opinion, the financial statements of the various funds and account groups of the City of X listed in the aforementioned table of contents present fairly the financial position of such funds and account groups at December 31, 19X2, and the results of operations of such funds for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

(s) *Firm Name*

February 12, 19X3

**GENERAL FIXED ASSET GROUP
OF ACCOUNTS NOT MAINTAINED**

Independent Auditors' Report

Honorable City Council,
City of X:

We have examined the financial statements of the various funds and the general long-term debt group of accounts of the City of X for the year ended December 31, 19X2, listed in the foregoing table of contents. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The City has not maintained a record of its general fixed assets, and accordingly a statement of general fixed assets, required by generally accepted accounting principles, is not included in the financial report.

In our opinion, the financial statements listed in the aforementioned table of contents present fairly the financial position of such funds and the general long-term debt group of accounts of the City of X at December 31, 19X2, and the results of operations of such funds for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

(s) Firm Name

February 12, 19X3

SCOPE OF EXAMINATION
LIMITED TO RECORDED REVENUES

Independent Auditors' Report

Honorable City Council,
City of X:

We have examined the balance sheet of the Parking Authority Fund of the City of X as of December 31, 19X2, and the related statements of revenue and expense, retained earnings, and changes in financial position. Except as disclosed in the following paragraph, our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

A substantial portion of the revenue of the Parking Authority consists of coin collections from meters on public parking lots. It was not practicable to satisfy ourselves with respect to such revenues beyond the amounts recorded as received.

In our opinion, except for the effects, if any, of the matter discussed in the preceding paragraph, the aforementioned financial statements present fairly the financial position of the Parking Authority Fund of the City of X at December 31, 19X2, and the results of its operations and its changes in financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

(s) *Firm Name*

February 12, 19X3

Note: The auditor should consider whether the potential amount of unrecorded revenue is so great as to lead him to disclaim an opinion.

**SPECIAL REPORT—OPINION ON
STATEMENTS PREPARED ON CASH BASIS**

Independent Auditors' Report

Honorable City Council,
City of X:

We have examined the statement of assets and liabilities arising from cash transactions of the General Fund of the City of X as of December 31, 19X2, and the related statement of revenues collected and expenditures paid for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The aforementioned statements do not give effect to accounts receivable, accounts payable, and accrued items. Accordingly, the statements do not present financial position and results of operations in conformity with generally accepted accounting principles.

In our opinion, the accompanying statements present fairly the assets and liabilities of the General Fund of the City of X at December 31, 19X2, arising from cash transactions, and its revenues collected and expenditures paid during the year then ended, on a basis consistent with that of the preceding year.

(s) Firm Name

February 12, 19X3

Note: See SAS No. 1, section 620, paragraphs .05-.06, for special guidance.

ADVERSE OPINION BECAUSE OF INADEQUACIES IN
ACCOUNTING FOR UTILITY PLANT IN SERVICE
IN AN ENTERPRISE FUND

Independent Auditors' Report

Honorable City Council,
City of X:

We have examined the balance sheet of the Water Utility Fund of the City of X as of December 31, 19X2, and the related statements of revenue and expense, changes in retained earnings, and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

No depreciation has been recorded on utility plant in service and contributions in aid to construction have not been capitalized in current and prior years. The amounts by which the financial statements would change, if these items were included, while material, cannot be determined.

Because of the material effect of the above omissions, which are at variance with generally accepted accounting principles, in our opinion, the aforementioned financial statements do not present fairly the financial position of the Water Utility Fund of the City of X at December 31, 19X2, or the results of its operations or changes in its financial position for the year then ended in conformity with generally accepted accounting principles.

(s) *Firm Name*

February 12, 19X3

DISCLAIMER OF OPINION WITH RESPECT
TO SPECIAL ASSESSMENT FUNDS,
RESULTING FROM LACK OF AVAILABILITY
OF RECORDS

Independent Auditors' Report

Honorable City Council,
City of X:

We have examined the financial statements of the various funds and account groups of the City of X for the year ended December 31, 19X2, listed in the foregoing table of contents. Our examination was made in accordance with generally accepted auditing standards and, except as to special assessment funds, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The records of the special assessment funds were incomplete as to assessments receivable and construction contracts payable. Because we were unable to satisfy ourselves by appropriate audit tests or by other means as a result of such incomplete records, we are unable to express an opinion on the accompanying financial statements of the special assessment funds.

In our opinion, the financial statements listed in the foregoing table of contents, other than the financial statements of the special assessment funds, present fairly the financial position of the various funds and account groups of the City of X at December 31, 19X2, and the results of operations of such funds for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

(s) *Firm Name*

February 12, 19X3

REPORT ON FINANCIAL STATEMENTS PREPARED
IN ACCORDANCE WITH LEGAL REQUIREMENTS

Independent Auditors' Report

Honorable City Council,
City of X:

We have examined the statements of operating and restricted funds and net cash earnings and allocation thereof under Revenue Bond Ordinance 1234 of the Water and Sewer Fund of the City of X for the year ended December 31, 19X2. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The aforementioned statements have been prepared in accordance with the provisions of Bond Ordinance 1234 and do not present either financial position or results of operations in conformity with generally accepted accounting principles.

In our opinion, the aforementioned statements for the year ended December 31, 19X2, present fairly the information contained therein, in conformity with the provisions of Bond Ordinance 1234, applied on a basis consistent with that of the preceding year.

(s) *Firm Name*

February 12, 19X3

BOND COMPLIANCE LETTER

Independent Auditors' Report

Honorable City Council,
City of X:

We have examined the balance sheet of the Waterworks Fund of the City of X as of December 31, 19X2, and the related statements of revenue and expense, changes in retained earnings, and changes in financial position for the year then ended, and have issued our report thereon dated February 12, 19X3. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In the course of our examination, nothing came to our attention that caused us to believe there has been any lack of compliance with the accounting or reporting requirements of Section 12 of the bond ordinance governing the waterworks revenue bond issue dated September 1, 19XX.

(s) *Firm Name*

February 12, 19X3

Note: If the auditor is able to make sufficient tests to enable him to form an opinion that the provisions of the bond ordinance with respect to which he is reporting have been complied with, he may wish to express an opinion as to compliance.

Appendixes

Principles of Governmental Accounting and Reporting

The following “Principles of Governmental Accounting and Reporting” has been reproduced from *Governmental Accounting, Auditing, and Financial Reporting* by the National Committee on Governmental Accounting.

Legal Compliance and Financial Operations

1. A governmental accounting system must make it possible: (a) to show that all applicable legal provisions have been complied with; and (b) to determine fairly and with full disclosure the financial position and results of financial operations of the constituent funds and self-balancing account groups of the governmental unit.

Conflicts Between Accounting Principles and Legal Provisions

2. If there is a conflict between legal provisions and generally accepted accounting principles applicable to governmental units, legal provisions must take precedence. Insofar as possible, however, the governmental accounting system should make possible the full disclosure and fair presentation of financial position and

operating results in accordance with generally accepted principles of accounting applicable to governmental units.

The Budget and Budgetary Accounting

3. An annual budget should be adopted by every governmental unit, whether required by law or not, and the accounting system should provide budgetary control over general governmental revenues and expenditures.

Fund Accounting

4. Governmental accounting systems should be organized and operated on a fund basis. A fund is defined as an independent fiscal and accounting entity with a self-balancing set of accounts recording cash and/or other resources together with all related liabilities, obligations, reserves, and equities which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations.

Types of Funds

5. The following types of funds are recognized and should be used in accounting for governmental financial operations as indicated.

(1) The General Fund to account for all financial transactions not properly accounted for in another fund;

(2) Special Revenue Funds to account for the proceeds of specific revenue sources (other than special assessments) or to finance specified activities as required by law or administrative regulation;

(3) Debt Service Funds to account for the payment of interest and principal on long-term debt other than special assessment and revenue bonds;

(4) Capital Projects Funds to account for the receipt and disbursement of moneys used for the acquisition of capital facilities other than those financed by special assessment and enterprise funds;

(5) Enterprise Funds to account for the financing of services to the general public where all or most of the costs involved are paid in the form of charges by users of such services;

(6) Trust and Agency Funds to account for assets held by a governmental unit as trustee or agent for individuals, private organizations, and other governmental units;

(7) Intragovernmental Service Funds to account for the financing of special activities and services performed by a designated organization unit within a governmental jurisdiction for other organization units within the same governmental jurisdiction;

(8) Special Assessment Funds to account for special assessments levied to finance public improvements or services deemed to benefit the properties against which the assessments are levied.

Number of Funds

6. Every governmental unit should establish and maintain those funds required by law and sound financial administration. Since numerous funds make for inflexibility, undue complexity, and unnecessary expense in both the accounting system and the over-all financial administration, however, only the minimum number of funds consistent with legal and operating requirements should be established.

Fund Accounts

7. A complete self-balancing group of accounts should be established and maintained for each fund. This group should include all general ledger accounts and subsidiary records necessary to reflect compliance with legal provisions and to set forth the financial position and the results of financial operations of the fund. A clear distinction should be made between the accounts relating to current assets and liabilities and those relating to fixed assets and liabilities. With the exception of Intragovernmental Service Funds, Enterprise Funds, and certain Trust Funds, fixed assets should not be accounted for in the same fund with the current assets, but should be set up in a separate, self-balancing group of accounts called the General Fixed Asset Group of Accounts. Similarly, except in Special Assessment Enterprise and certain Trust Funds, long-term liabilities should not be carried with the current liabilities of any fund, but should be set up in a separate, self-balancing group of ac-

counts known as the General Long-Term Debt Group of Accounts.

Valuation of Fixed Assets

8. The fixed asset accounts should be maintained on the basis of original cost, or the estimated cost if the original cost is not available, or, in the case of gifts, the appraised value at the time received.

Depreciation

9. Depreciation on general fixed assets should not be recorded in the general accounting records. Depreciation charges on such assets may be computed for unit cost purposes, provided such charges are recorded only in memorandum form and do not appear in the fund accounts.

Basis of Accounting

10. The accrual basis of accounting is recommended for Enterprise, Trust, Capital Projects, Special Assessment, and Intra-governmental Service Funds. For the General, Special Revenue, and Debt Service Funds, the modified accrual basis of accounting is recommended. The modified accrual basis of accounting is defined as that method of accounting in which expenditures other than accrued interest on general long-term debt are recorded at the time liabilities are incurred and revenues are recorded when received in cash, except for material or available revenues which should be accrued to reflect properly the taxes levied and the revenues earned.

Classification of Accounts

11. Governmental revenues should be classified by fund and source. Expenditures should be classified by fund, function, organization unit, activity, character, and principal classes of objects in accordance with standard recognized classification.

Common Terminology and Classification

12. A common terminology and classification should be used consistently throughout the budget, the accounts, and the financial reports.

Financial Reporting

13. Financial statements and reports showing the current condition of budgetary and proprietary accounts should be prepared periodically to control financial operations. At the close of each fiscal year, a comprehensive annual financial report covering all funds and financial operations of the governmental unit should be prepared and published.

Applicability of Professional Pronouncements to Financial Statements of Governmental Units

General

The following analysis of professional pronouncements has been provided to assist the independent auditor. It was developed from a detailed review of all Accounting Research Bulletins (No. 43, chapters 1 to 15, and Nos. 44 to 51) issued by the Institute's committee on Accounting Procedure, all Opinions (Nos. 1 to 31) and Statements Nos. 1 to 4 issued by the Accounting Principles Board, and Statement on Auditing Standards No. 1, issued by the auditing standards executive committee. No pronouncements of the Financial Accounting Standards Board had been released at the date of preparation of this guide. The scope of coverage in the review included both accounting principles and disclosure requirements considered applicable to financial statements of governmental units. These are separately delineated in the analysis of each pronouncement in this guide.

Generally accepted accounting principles evolve and change. Pronouncements issued by the American Institute of Certified Public Accountants and the Financial Accounting Standards Board give recognition to such changes. The first reporting standard in section 400 of Statement on Auditing Standards No. 1 contemplates that the independent auditor will be alert to such pronouncements. He must also be alert to changes that become acceptable through common usage although not a subject of a professional pronouncement.

APPLICABILITY TO ENTERPRISE, INTRAGOVERNMENTAL SERVICE, AND CERTAIN TRUST FUNDS

In enterprise funds, intragovernmental service funds, and certain trust funds, in which a significant accounting aspect is net income measurement, there is a strong resemblance to commercial enterprises organized for profit. In these types of funds, all professional pronouncements are applicable unless the subject matter of a particular pronouncement is not relevant. For example, these funds do not pay income taxes and do not issue capital stock; thus, pronouncements on these subjects are not relevant.

APPLICABILITY TO ALL OTHER FUNDS

With respect to applicability to all other funds, namely, general, special revenue, debt service, capital projects, certain trust, and special assessment funds and the general fixed assets and general long-term debt groups of accounts, some professional pronouncements are fully or partially applicable but others are inapplicable since they are directed solely at profit-making organizations. The Accounting Research Bulletins and Accounting Principles Board Opinions considered to have at least limited applicability to these funds and account groups are set forth below.

ACCOUNTING RESEARCH BULLETINS

<u>No.</u>	<u>Chapter</u>	<u>Section</u>	<u>Topic</u>
43	2	A	Comparative Financial Statements
43	3	A	Marketable Securities
43	4	—	Inventory Pricing
43	6	—	Contingency Reserves
43	9	A	Depreciation and High Costs
43	10	A	Real and Personal Property Taxes
44	—	—	Declining Balance Depreciation
50	—	—	Contingencies

ACCOUNTING PRINCIPLES BOARD OPINIONS

<u>No.</u>	<u>Para.</u>	<u>Topic</u>
5 and 31	—	Reporting of Leases and Disclosure of Lease Commitments in Financial Statements of Lessees
7	—	Accounting for Leases in Financial Statements of Lessors
8	—	Accounting for the Cost of Pension Plans
9	—	Reporting the Results of Operations
12	2, 3	Classification and Disclosure of Allowances
12	5	Disclosure of Depreciable Assets
17	—	Intangible Assets
20	—	Accounting Changes
21	—	Interest on Receivables and Payables
22	—	Disclosure of Accounting Policies
26	—	Early Extinguishment of Debt

For convenience in reference, appropriate discussion of each bulletin or Opinion considered applicable to the governmental funds named above is arranged or grouped under subject matter headings rather than in number order.

DISCLOSURE REQUIREMENTS FOR FINANCIAL STATEMENTS OF GOVERNMENTAL UNITS

General

The requirements imposed upon independent auditors for disclosures in financial statements of governmental units, as well as of commercial enterprises, are found in Statement on Auditing Standards No. 1, as expressed in the four standards of reporting. In a broad sense, each of these four standards constitutes a form of disclosure, but the third standard of reporting, in particular, places upon the auditor the responsibility to determine that all necessary information is in the financial statements or in notes thereto. The third standard of reporting is as follows:

Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

The specific disclosure requirements on financial statements of commercial enterprises are numerous and, as stated earlier, are found throughout the Institute's accounting literature. This literature consists of, at the date of issuing this audit guide, Accounting Research Bulletins 43, chapters 1 through 15 and 44 through 51; Accounting Principles Board Opinions, Nos. 1 through 31; APB Statements 1 through 4; and Statement on Auditing Standards No. 1. The applicability of these disclosure requirements to financial statements of governmental units is discussed in this appendix. The reader is cautioned, however, to also review pronouncements by the Financial Accounting Standards Board and by the auditing standards executive committee of the Institute, as well as to be alert to disclosure requirements found in sources outside the formal literature of these professional bodies. These have not been researched for the purpose of including in this appendix those requirements considered applicable to financial statements of governmental units.

Adequate Disclosure Defined

Accounting Principles Board Statement No. 4, paragraph 106, defines adequate disclosure as follows:

Financial information that meets the qualitative objectives of financial accounting also meets the reporting standard of adequate disclosure. Adequate disclosure relates particularly to objectives of relevance, neutrality, completeness, and understandability. Information should be presented in a way that facilitates understanding and avoids erroneous implications. The headings, captions, and amounts must be supplemented by enough additional data so that their meaning is clear but not by so much information that important matters are buried in a mass of trivia.

Paragraph 199 of APB Statement No. 4 elucidates further on the meaning of full disclosure, as follows:

In addition to informative classifications and segregation of data, financial statements should disclose all additional information that is necessary for fair presentation in conformity with generally accepted accounting principles. Notes that are necessary for adequate disclosure are an integral part of the financial statements.

Financial statements cannot provide all of the information available about an enterprise. They are essentially summaries of a large quantity of detailed information. Furthermore, the information given on the face of the statements is largely restricted to that which can be represented by a number described by a very few words. Normally information of that type needs amplification to make it most useful, and both the financial statements and the notes are necessary for adequate disclosure.

SPECIFIC APPLICATION OF PROFESSIONAL PRONOUNCEMENTS TO FINANCIAL STATEMENTS OF BUDGETARY AND OTHER FUNDS

The following descriptions of specific application of Accounting Research Bulletins and Accounting Principles Board Opinions apply only to the general, special revenue, debt service, capital projects, certain trust, and special assessment funds, and the general fixed assets and general long-term debt groups of accounts when the relevant circumstances are present.

Comparative Financial Statements

ARB No. 43, chapter 2, section A, concludes that ordinarily in any one year it is desirable that the balance sheet, the income statement, and the surplus (retained earnings) statement be given for one or more preceding years as well as for the current year.

Comparative financial statements are frequently meaningful in government and, in such instances, should be used. On the other hand, sometimes a combined balance sheet of all funds instead of separate balance sheets of individual funds is considered to be a more meaningful form of presentation of financial position. Where the latter presentation is used, it might be impractical to present it in comparative form. Moreover, in government frequently the most meaningful comparison in operating statements of budgetary funds is of actual results against the budget. However, one mode of comparison that is sometimes desirable is a comparison of actual results with the budget and also with the prior year's actual results.

Reporting the Results of Operations

APB Opinion No. 9, "Reporting the Results of Operations," Part I—Net Income and Treatment of Extraordinary Items and Prior Period Adjustments; and APB Opinion No. 20, "Accounting Changes" are discussed in the following sections.

Applicable Accounting Principles. APB Opinion No. 9 is concerned with the measurement and statement presentation of net income of business entities. It differentiates between items in net income before extraordinary items, extraordinary items shown separately as an element of net income, and a limited area of prior period adjustments to retained earnings.

APB Opinion No. 20 outlines changes in accounting principles and accounting estimates, which are to be included in net income for the period, and the correction of an error in previously issued financial statements, which should be reported as a prior period adjustment.

To the extent appropriate, these Opinions should be applied. However, there is no need to apply the criteria for extraordinary items related to the current period because there would be no purpose served in separating the revenue and expenditure elements in the operating statements of budgetary or other funds similar in purpose into the operating and non-operating (extraordinary) categories inherent in income statements of commercial enterprises.

In substance, the only portions of the APB Opinions Nos. 9 and 20 considered applicable are those which set forth criteria for current period or prior period adjustments and related disclosure requirements. (The very limited areas of adjustments to Retained Earnings for "prior period adjustments" under criteria set forth in Opinion No. 9, paragraphs 23 and 25, and correction of an error in the financial statements of a prior period, covered in Opinion No. 20, paragraphs 13 and 36 would apply to fund balance adjustments in budgetary and other funds similar in purpose.)

In applying the above criteria, the terminology used therein should be adapted to the statement format of budgetary funds. For example, where APB Opinion No. 20 uses the expression "effect on income," the substitute expressions, "effect on expendi-

tures” or “effect on revenue” would generally serve as translations for funds of governmental units. Net income usage in APB Opinion No. 9 can be similarly translated.

Thus, there should be relatively few adjustments to the fund balance account. Most transactions should be treated as revenues or expenditures.

Following are several examples which illustrate the applicability of these Opinions:

1. An appropriate prior period adjustment is a change from an unacceptable to an acceptable accounting method. In the period in which a fund changes its method of reporting from a cash, or other incomplete method, to the accounting methods recommended within this guide, the effect of the change should be reported as a “prior period adjustment,” in conformity with paragraph 18 of APB Opinion No. 9 (see also paragraphs 13 and 36 of APB Opinion No. 20).
2. Recovery of items previously expensed or refunds of items previously recorded as revenue should be shown in the statement(s) of revenues and/or expenditures. For example, collections of taxes and accounts receivable previously written off have sometimes been credited to fund balance. These items should be recorded as revenue in the current accounting period.
3. Adjustments for a difference between a prior year’s reserve for encumbrances and the actual expenditures do not qualify as prior period adjustments under APB Opinion No. 9. Instead, they should be reported in the operating statement as a debit or credit to a miscellaneous or sundry expenditure account in the non-departmental category.
4. Differences between estimated accounts receivable, including grants where these have been accrued, and later actual values may be subject to the rules for changes in accounting estimates, i.e., reflected in the operating statement (APB Opinion No. 9, paragraph 24). All of these items should be reported as current year items.

Interfund transfers comprise a special situation in government, which was discussed in Chapter 2.

Applicable Disclosure Requirements. APB Opinion No. 9, paragraph 26, states:

When prior period adjustments are recorded, the resulting effects . . . on the . . . (revenues and expenditures) of prior periods should be disclosed in the annual report for the year in which the adjustments are made. When financial statements for a single period only are presented, this disclosure should indicate the effects of such restatement on the . . . (fund balance) at the beginning of the period and on the . . . (revenues and expenditures) of the immediately preceding period. When financial statements for more than one period are presented, which is ordinarily the preferable procedure, the disclosure should include the effects for each of the periods included in the statements. . . . Disclosure of restatements in annual reports issued subsequent to the first such post-revision disclosure would ordinarily not be required.

APB Opinion No. 20, paragraphs 17 and 37, states that:

The nature of and justification for a change in accounting principle and its effect on . . . (revenues and expenditures) should be disclosed in the financial statements of the period in which the change is made. The justification for the change should explain clearly why the newly adopted accounting principle is preferable. (Paragraph 17)

The nature of an error in previously issued financial statements and the effect of its correction on . . . (revenues and expenditures) should be disclosed in the period in which the error was discovered and corrected. Financial statements of subsequent periods need not repeat the disclosures. (Paragraph 37)

Disclosure of Market Value of Marketable Securities. The market value of readily marketable securities or other temporary investments should be disclosed parenthetically in the financial statements or in a note thereto. (ARB No. 43, chapter 3, section A)

Disclosure of Notes or Accounts Receivable Due From Officials or Employees

ARB 43, chapter 1, section A, paragraph 5, states:

Notes or accounts receivable due from . . . (officials or) employees . . . must be shown separately and not included under a general heading such as notes receivable or accounts receivable.

Inventories

The subject matter of ARB No. 43, chapter 4 is inventory of goods that are held directly or indirectly for resale. Such inventories are very unusual in government, where inventory is commonly held for consumption. In government, the cost or market rule would not generally apply. Cost would be preferable because any inventory that is carried in an expendable fund is simply a deferred expenditure.

Disclosure of Basis of Stating Inventories. ARB No. 43, chapter 4, statements 8 and 9, states that:

The basis of stating inventories must be consistently applied and should be disclosed in the financial statements; whenever a significant change is made therein, there should be disclosure of the nature of the change and, if material, the effect on . . . (expenditures). (Statement 8)

Only in exceptional cases may inventories properly be stated above cost. . . . Where goods are (justifiably) stated above cost this fact should be fully disclosed. (Statement 9)

This disclosure requirement will apply only infrequently to governmental funds other than enterprise and intragovernmental service funds because inventories carried for resale are very seldom held. Expendable supplies are only infrequently found to be inventoried.

Interest on Receivables and Payables

APB Opinion No. 21 sets forth the broad guidelines for appropriate accounting when the face amount of certain notes receivable or payable does not reasonably represent the present value of the consideration given or received in the exchange transaction. While it is unlikely that such transactions will be frequent in government, the Opinion's guidelines would apply in relevant circumstances.

Classification and Disclosure of Allowances

APB Opinion No. 12, paragraphs 2 and 3, states that:

Although it is generally accepted that accumulated allowances for depreciation . . . and asset valuation allowances for losses

such as those on receivables and investments should be deducted from the assets to which they relate, there are instances in which these allowances are shown among liabilities or elsewhere on the credit side of the balance sheet. (Paragraph 2)

It is the Board's opinion that such allowances should be deducted from the assets or groups of assets to which the allowances relate, with appropriate disclosure. (Paragraph 3)

One example among budgetary funds to which these paragraphs would apply would be an allowance for estimated uncollectible property taxes, where revenue therefrom had been accrued, which should be deducted from the related receivable on the balance sheet. Another would be where a governmental unit elected the procedure described in Chapter 2 of this guide of computing depreciation on general fixed assets. The accumulated allowance for such depreciation should be deducted from the related assets in the statement of general fixed assets.

Disclosure of Depreciable Assets

APB Opinion No. 12, paragraphs 5 b, c, and d, is applicable only where a governmental unit elects to compute depreciation on general fixed assets under the alternative procedure provided for in Chapter 2 of this guide:

Because of the significant effects . . . of the depreciation method or methods used, the following disclosures should be made in the . . . (statement of general fixed assets) or in notes thereto:

b. Balances of major classes of depreciable assets, by nature or function, at the balance-sheet date,

c. Accumulated depreciation, either by major classes of depreciable assets or in total, at the balance sheet date, and

d. A general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets. (Paragraphs 5 b, c, and d)

Leases

Reporting of Leases in Financial Statements of Lessee. A brief discussion of accounting principles relating to reporting of leases in financial statements of lessees, as set forth in APB Opinion No. 5, is as follows.

Applicable accounting principles—Opinion No. 5 discusses the disclosure in the balance sheet of property held as an asset and a related rental obligation in connection with certain leases. Such disclosure is dependent upon whether the lease is in substance a purchase of the property rather than a right to the use of the property.

An example of a lease which might fall into the category of a purchase of property could be that of heavy equipment purchased under a “lease-purchase” contract with a commercial entity. The rental agreement normally provides that title to the property remains in the lessor and that the lessee has no title to or interest in the property until and if the final rental payment has been made.

The appropriation (budget) document of governmental units is by law usually prepared on an annual basis, and many jurisdictions are prevented by state law from encumbering (except by bonded or time warrant indebtedness after sanction by its citizens) the resources of future periods for purchases made in the current period. An open account (and in most cases unsecured notes) with a maturity beyond the current fiscal period would not be collectible in those jurisdictions. To lease property in these circumstances requires special lease arrangements that generally provide for a year-to-year lease or makes the rental payment contingent upon funds being appropriated in the future. The governmental unit technically has not obligated the revenues of a succeeding period. It can stop payment at any time and surrender the property. No further liability exists thereafter on either side.

Under these circumstances, the governmental unit does not yet own the property and may never own it, even though the presumption is that it will. Thus, the unit should not include the item in its assets, nor record the future installments as liabilities.

If the right to cancel is not present, then the related provisions of Opinion No. 5 should be applied in those instances where a purchase has effectively occurred.

Disclosure of lease commitments by lessees—The reader is referred to paragraphs 7 to 11 of Opinion No. 31 for detailed guidance as to disclosure of lease commitments by lessees.

Accounting for Leases in Financial Statements of Lessors. A brief discussion on accounting for leases in financial statements of lessors is as follows.

Applicable accounting principles—Opinion No. 7 sets forth the Board's views in accounting for revenues and expenses of lessors and the related investment in the leased property. There are two important examples of a governmental entity being a lessor of property. The first would be where a building authority acts as a financing intermediary, to obtain funds to construct property for use by other governmental units. The second situation would be leases related to industrial bond issues, which were common a few years ago until changes in the income tax rules inhibited these transactions.

In the first instance, a municipality might have a direct or indirect interest in the transaction, e.g., a special authority is set up to finance and lease property with the municipality as an obligor of the liabilities of the special authority. As discussed on pages 83 and 84, the provisions of APB Opinion No. 7 should be followed in determining the appropriate accounting.

Disclosures respecting leases in financial statements of lessors—APB Opinion No. 7, paragraph 16, states that:

In addition to an appropriate description in the balance sheet of the investment in property held for or under lease (see paragraphs 13 to 15), the principal accounting methods used in accounting for leasing activities should be disclosed. Further, where leasing is a substantial portion of a nonfinancing institution's operations, the Board believes that financial statements should disclose sufficient information to enable readers to assess the significance of leasing activities to the . . . (unit). Leases and leased property are also subject to the conventional disclosure requirements affecting financial statements as, for example, disclosure of pledges of leased property and leases as security for loans.

In the case of leases between a special authority and a municipality or other controlling governmental unit, appropriate disclosure should be made in the financial statements of the terms of the lease and the reversion of title to the lessee at the expiration of the lease. In those instances where a governmental entity

is contingently liable as a guarantor of debt in a transaction financed through a related entity, such obligation should also be disclosed in the financial statements.

Intangible Assets

Intangible assets are rarely encountered in governmental operations. Nevertheless, if intangible assets of the kind dealt with in this bulletin exist in the financial activities of budgetary and other funds of a governmental entity, they should be classified, amortized, and written off in accordance with the provisions of APB Opinion No. 17.

Early Extinguishment of Debt

APB Opinion No. 26, paragraphs 19 and 20, is concerned with extinguishment of debt before scheduled maturities, whether by call, refunding, or purchase in the open market. The Board has concluded "that all extinguishments of debt . . . are fundamentally alike. . . . [and that] The accounting for such transactions should be the same regardless of the means used to achieve the extinguishment." (Paragraph 19)

Paragraph 20 states: "*Disposition of amounts.* A difference between the reacquisition price and the net carrying amount of the extinguished debt should be recognized currently in income of the period of extinguishment as losses or gains and identified as a separate item. . . . Gains and losses should not be amortized to future periods."

Pension Plans and Pension Funds

Accounting for the Cost of Pension Plans. In the governmental area, two basic types of pension funds exist. The first type is generally organized on a state-wide basis, operated by a central or separate agency, wherein employees of many local governmental units are participants. The second type is operated by and for the local unit, comprising such pension plans as Police-men's Pension Fund, Firemen's Pension Fund, etc.

APB Opinion No. 8 is concerned with the determination of the amount of pension cost for accounting purposes. Accordingly,

Opinion No. 8 is applicable to the cost of pension plans to contributing governmental units. However, Opinion No. 8 does not address the subject of accounting for the operations of a pension or retirement fund itself.

Disclosures Respecting Pension Plans. Paragraph 46 of APB Opinion No. 8, quoted below, is applicable to the cost of pension plans to contributing governmental units only and not to a pension or retirement fund itself.

The Board believes that pension plans are of sufficient importance to an understanding of financial position and results of operations that the following disclosures should be made in financial statements or their notes:

1. A statement that such plans exist, identifying or describing the employee groups covered.
2. A statement of the [unit's] accounting and funding policies.
3. The provision for pension cost for the period.
4. The excess, if any, of the actuarially computed value of vested benefits over the total of the pension fund and any balance-sheet pension accruals, less any pension prepayments or deferred charges.
5. Nature and effect of significant matters affecting comparability for all periods presented, such as changes in accounting methods (actuarial cost method, amortization of past and prior service cost, treatment of actuarial gains and losses, etc.), changes in circumstances (actuarial assumptions, etc.), or adoption or amendment of a plan.

Paragraph 46 also contains an example of what the Board considers to be appropriate disclosure and reference thereto is made herein.

In applying Opinion No. 8, difficulty may be encountered in obtaining data with respect to the excess, if any, of the actuarially computed value of vested benefits over the total of the pension fund and any balance-sheet pension accruals, less any pension prepayments or deferred charges. In such instances, the financial statements of the governmental unit should contain a note thereto disclosing that the above-described amount is not available.

Depreciation

The bulletins and opinions discussed below are applicable only where a governmental unit elects to compute depreciation on general fixed assets under the alternative procedure provided for in Chapter 2 of this guide.

Depreciation and High Costs. ARB No. 43, chapter 9, section A, discusses the use of replacement cost depreciation and reaffirms ARB No. 33 which had opposed it except in terms of supplementary information.

The only likely application of replacement cost in government would be the possibility that in making grant applications the governmental unit might use depreciation based on replacement cost instead of historical cost. This would depend on guidelines of the granting agency.

Declining Balance Depreciation. If depreciation is computed on general fixed assets, declining balance depreciation described in ARB No. 44 (revised), which meets the requirements of being “systematic and rational,” is one of the available methods.

Accrual of Property Tax Expense

ARB No. 43, chapter 10, section A, would generally apply in instances when governmental units have a liability for property taxes. This would be rare, except in year of acquisition of property.

Disclosure of Accounting Policies

Paragraph 12b of APB Opinion No. 22 provides for disclosure of “Principles and methods peculiar to the industry in which the reporting entity operates, even if such principles and methods are predominantly followed in that industry.” For purposes of this Opinion, governmental units would be considered an “industry.” Thus, disclosures should encompass the principles and methods peculiar to the modified accrual method of accounting.

APB Opinion No. 22, paragraphs 8, 9, 12, and 15, is also applicable, as follows:

The Board concludes that information about the accounting policies adopted by a reporting entity is essential for financial

statement users. When financial statements are issued purporting to present fairly financial position . . . and results of operations in accordance with generally accepted accounting principles, a description of all significant accounting policies of the reporting entity should be included as an integral part of the financial statements. . . . (Paragraph 8)

The Board also concludes that information about the accounting policies adopted and followed by not-for-profit entities should be presented as an integral part of their financial statements. (Paragraph 9)

Disclosure of accounting policies should identify and describe the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position . . . or results of operations. . . . (Paragraph 12)

The Board recognizes the need for flexibility in matters of format (including the location) of disclosure of accounting policies. . . . The Board believes that the disclosure is particularly useful if given in a separate *Summary of Significant Accounting Policies* preceding the notes to financial statements or as the initial note. Accordingly, it expresses its preference for that format under the same or a similar title. (Paragraph 15)

Contingencies

Applicable Accounting Principles. ARB No. 43, chapter 6, discusses contingency reserves and generally disfavors credits or charges to net income related to such reserves. The only likely application of this in government (other than in Enterprise Funds) might be in a pension fund. If so, paragraphs 7 and 8 of chapter 6 of ARB No. 43 could apply.

Disclosure of Contingencies. ARB No. 50, paragraph 5, states:

Disclosure of contingencies referred to in paragraph 2 should be made in financial statements or in notes thereto. The disclosure should be based as to its extent on judgment in the light of the specific circumstances and should indicate the nature of the contingency, and should give an appraisal of the outlook. If a monetary estimate of the amount involved is not feasible, disclosure should be made in general terms describing the contingency and explaining that no estimated amount is determinable. When amounts are not otherwise determinable, it may be appropriate to indicate the opinion of management (governmental officials) or counsel as to the amount which may be involved. In some

cases, such as a law suit involving a substantial amount, management (governmental officials) may reasonably expect to settle the matter without incurrence of any significant liability; however, consideration should be given to disclosing the existence of the litigation and the opinion of management (governmental officials) or counsel with respect thereto. Although disclosures discussed here should be made with respect to those contingencies which may result in material gains or assets as well as with respect to those which may result in material losses or liabilities, care should be exercised in the case of gains or assets to avoid misleading implications as to the likelihood of realization. . . .

Subsequent Events

Only part of the examples of subsequent events discussed in paragraphs .02 through .09 of Statement on Auditing Standards No. 1, section 560, would ever have application to budgetary and other governmental funds. In such event, however, judgment must be exercised as to whether they are of the type that requires adjustment of the financial statements or disclosure of the applicable events in notes thereto. The auditor should review the entire statement for guidance in the event of its application.

Subsequent Discovery of Facts Existing at Date of the Auditor's Report

If the circumstances cited in Statement on Auditing Standards No. 1, section 561, arise in the conduct of audits of budgetary and other governmental funds, the auditor should review that section for guidance, with particular attention to paragraph .06.

Summary of Applicability of Accounting Research Bulletins and Accounting Principles Board Opinions

In summary, these bulletins and Opinions have wide application to enterprise, intragovernmental service, and certain trust funds, where the net income measurement is parallel to that in business enterprises organized for profit. Further, the auditor should be alert to application of existing and future pronouncements to budgetary and other similar funds, although, in most instances, such applicability may be quite limited.

Disclosure Requirements Frequently Applicable to Financial Statements of Governmental Units Not Found in Institute Literature

One disclosure requirement that is broadly applicable to the types of funds mentioned above but that is found outside Institute literature is included here for the convenience of the reader.

Disclosure of Details of Long-Term Debt. With respect to long-term debt set forth in financial statements of enterprise, intragovernmental service, certain trust funds, special assessment funds, or the statement of general long-term debt, there should be disclosed in the financial statements or in a note thereto the essential details of such debt, including but not necessarily limited to, the date of the obligation, original amount, interest rate, maturity date, repayment terms, and details as to assets pledged, including, where applicable, the market value of collateral pledged.

The reader should be alert to other disclosure requirements existing outside the field of Institute literature that may be applicable to financial statements of governmental units.

Statements of Committee Members Who Qualify Their Assent to the Publication of this Audit Guide

Mr. DeLap assents to the publication of the guide with the following qualification:

He does not agree with the “guidelines for proper accounting for interfund transfers” as stated in Chapter 2, insofar as they require certain interfund transfers to be recorded in the fund balance accounts. It is his opinion that any transfer received from any other fund, which increases a budgetary fund’s equity, should be recorded as revenue, and any transfer from a budgetary fund, which decreases fund equity should be recorded as an expenditure.

Mr. Froehlich assents to publication of the guide with the following qualifications:

- While it is agreed that in local government there may be no direct causative relationships between the incurrence of costs and revenues (sales) as in private industry, there is a need to apply a “matching principle” to the overall relationships of planned costs and required funding and actual costs and actual funding on the bases of the benefit (budget) year and non-profit (balanced budget) operational concepts. The guide fails generally to consider this principle and its implications, for example in its requirement for cash-basis accounting for property taxes where all of the payments are not due within the budget year. Property taxes, usually a significant item, become a lien on the property and are measurable when levied. The receivable and the revenue should be recognized when the levy is made, regardless of due dates on the tax bills or their timely mailing.
- The guide requires non-recurring transfers between funds which represent transfers of equity to be treated as entries to fund balance instead of as revenues and expenditures of the individual fund entities involved. He disagrees and suggests that for purposes of control such items be included in revenues and expenditures and the related budgets of the funds involved.
- The guide requires the inclusion of budget information in the financial statements as a matter of accounting principle and restricts the auditors’ responsibility to a determination that a budget has been formally approved and adopted. He believes that the guide should also require the application of generally accepted accounting principles in the development of the budget in order to insure the comparability of such budget data with the results of actual financial transactions. The auditor should also, as a minimum, make investigations and inquiries to satisfy himself that the financial statements overall present both budgeted and actual financial information on a comparable basis.

- The guide suggests in its delineation of acceptable accounting principles that “generally accepted accounting principles” are those principles that are appropriate in the circumstances, and requires traditional fund accounting concepts generally, but does not respond to the current need for full accrual (including depreciation) where program budgeting and accounting are considered necessary and appropriate. The guide’s prohibition against consolidated financial statements also fails to recognize a similar need for reporting and recognition of the governmental unit as an entity as well as reporting for sub-entities (funds). He therefore believes that, in addition to traditional fund accounting, full accrual and full cost accounting, and consolidated financial statements of the governmental entity as a whole should be recognized at least as alternative generally accepted accounting principles where such principles are considered “appropriate in the circumstances.”